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No. ———

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Petitioners,

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, and
THE UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the court of appeals erred in holding that the scope of review under 12 U.S.C. § 1464(d)(2)(E), which provides for an "action" in district court to determine "upon the merits" the legality of a government seizure of a savings and loan institution, can be limited consistent with the commands of the statute and the Due Process Clause to documents designated for the record by the government, thereby precluding the district court from considering:

a) any evidence submitted by the savings and loan's representatives, even though there was no prior opportunity to submit evidence concerning the grounds for the seizure because it was *ex parte* and without notice or prior proceeding; or

b) the whole administrative record in existence at the time of the seizure.

LIST OF PARTIES

Plaintiffs-Appellees below were Franklin Savings Association, a Kansas savings and loan association, and Franklin Savings Corporation, as controlling shareholder of Franklin Savings Association. Defendant-Appellant was the Director of the Office of Thrift Supervision. The United States of America intervened as a defendant.

Pursuant to Supreme Court Rule 29.1, Franklin Savings Corporation is identified as the parent of Franklin Savings Association. Neither Franklin Savings Corporation nor Franklin Savings Association has subsidiaries other than those wholly owned.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners, Franklin Savings Association and Franklin Savings Corporation, respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals is reported at 934 F.2d 1127 (10th Cir. 1991), and is included in the Appendix at pp. 1a-41a. The order of the court of appeals denying rehearing is included in the Appendix at pp. 42a-43a. The memorandum decision of the district court is reported at 742 F. Supp. 1089 (D. Kan. 1990), and is included in the Appendix at pp. 44a-116a. A notice regarding the order of the Director of the Office of Thrift Supervision ("OTS") was published at 55 Fed. Reg. 6869 (Feb. 27, 1990), and the order is included in the Appendix at pp. 117a-118a.

JURISDICTION

The judgment of the court of appeals was entered on May 28, 1991. Rehearing was denied on September 10, 1991. On November 27, 1991, Justice White extended the time for filing a writ of certiorari to and including January 8, 1992. This Court has jurisdiction under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Fifth Amendment to the United States Constitution provides, in pertinent part, that—

> No person shall be . . . deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. Const. amend V.

Section 5(d)(2)(E) of the Home Owners' Loan Act of 1933 ("HOLA"), 12 U.S.C. § 1464(d)(2)(E),[1] as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183, provides, in pertinent part:

> If, in the opinion of the Director, a ground for the appointment of a conservator or receiver for a savings association exists, the Director is authorized to appoint ex parte and without notice a conservator or receiver for the savings association. In the event of such appointment, the association may, within 30 days thereafter, bring an action in the United States

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[1] Under the Home Owners' Loan Act, the judicial review provision, containing the identical "on the merits" language, was designated § 1464(d)(6)(A). In 1989, the FIRREA amendments redesignated the provision § 1464(d)(2)(E), as it now appears in the United States Code. The most recent amendments to the Home Owners' Loan Act, contained in the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, H.R. Rep. No. 407, 102d Cong., 1st Sess., 39 (Nov. 26, 1991), make no substantive changes, but again redesignate the provision, which shall henceforth be § 1464(d)(2)(B). For ease of reference, petitioners cite the provision as § 1464(d)(2)(E) throughout.

district court for the judicial district in which the home office of such association is located, or in the United States District Court for the District of Columbia, for an order requiring the Director to remove such conservator or receiver, and the court shall upon the merits dismiss such action or direct the Director to remove such conservator or receiver.

STATEMENT AND INTRODUCTION OF THE CASE

This case arises out of the federal government's increasingly frequent regulatory seizures of financial institutions. Petitioners, Franklin Savings Association and Franklin Savings Corporation (collectively "Franklin"), brought an action in the United States District Court for the District of Kansas against the OTS Director, alleging that his seizure of Franklin Savings Association by appointment of a conservator was arbitrary because none of the statutory prerequisites for seizure was met in this case. The Director's seizure decision was made *ex parte* and without prior notice or hearing of any kind. Franklin's hearing before the district court was thus the first it had ever had on this issue before any tribunal—either before or after the regulatory takeover. Consistent with the plain meaning of 12 U.S.C. § 1464(d)(2)(E), which provides for an action in district court to determine "upon the merits" the legality of the Director's decision, the district court admitted Franklin's evidence supplementing the Director's record and rebutting the factual basis of the Director's claims. The district court overturned the seizure order, concluding that the Director's action was arbitrary, capricious and without factual basis.

The Tenth Circuit, however, reversed and held that the scope of review under § 1464(d)(2)(E) is severely limited: The district court may consider only those portions of the administrative record designated by the Director and upon which the Director claims to have relied ("the designated record"). See app. 15a-17a. The Tenth Circuit's ruling thus allows OTS to seize an institution

without notice of any kind so long as the district court is satisfied, solely upon the Director's designated record and without regard to any contrary evidence (unless voluntarily provided by the Director), that the Director's opinion was not arbitrary and capricious.

This ruling does violence to the due process rights of the institution and its owners and cannot be squared with the language of the statute. If left in place, the Tenth Circuit's decision will compound further the conflicts and confusion among lower courts as to the proper scope of judicial review under § 1464(d)(2)(E).

A. Factual Background

1. Franklin Savings is a century-old savings and loan association headquartered in Ottawa, Kansas, with eight branch offices in the State. Prior to its seizure Franklin had approximately $9 billion in assets, making it one of the largest savings and loans in the country. Like other savings and loans, Franklin earned most of its income from the difference between the interest received on assets (such as loans and mortgage-related assets) and the interest paid on deposits and other liabilities. From 1985 until the time of OTS's unexpected seizure of the institution, Franklin had annually achieved one of the highest regulatory ratings for overall safety and soundness. App. 65a-69a. Indeed, Franklin and its management had gained national prominence for their proven success in understanding and prudently addressing the economic risks inherent in the savings and loan business. App. 64a-65a.

Franklin's approach to managing risks had two principal components. First, Franklin invested primarily in securities guaranteed in whole or in part by the federal government (*e.g.*, mortgage-backed and mortgage derivative securities).[2] Second, Franklin developed a balanced (or "hedged") portfolio of such assets and their funding

[2] "Mortgage-backed" and "mortgage derivative" securities are pools of mortgages or cash flows therefrom.

sources, which minimized the impact of fluctuations in interest rates. Savings and loans that did not undertake a comprehensive and carefully managed hedging program saw the value of their portfolios fluctuate wildly and risked severe financial losses.[3]

The Federal Home Loan Bank Board, and OTS (after enactment of FIRREA in 1989) were Franklin's primary regulators. Franklin's operations were also regularly monitored and examined by the FDIC and state regulators. Prior to the seizure, Franklin had not been the subject of any regulatory proceeding beyond the ordinary examinations conducted by these agencies. There had been no administrative hearings or other enforcement proceedings. With respect to the three components of its operation of greatest concern to the Tenth Circuit —— mortgage derivative securities, brokered deposits, and hedging —— Franklin was in full compliance with all regulatory guidelines and rules at the time of its seizure. Indeed, just 30 days before the seizure, OTS's principal supervisory agent for Franklin confirmed (in a memorandum that the Director excluded from the designated

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[3] Interest rate fluctuations nearly bankrupted the savings and loan industry in the late 1970's and early 1980's. In the late 1970's, interest rates increased dramatically. Because government regulation capped the amount of interest that savings and loans could pay to their customers, those customers withdrew their money and invested elsewhere. Congress responded by removing the cap on interest rates. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132. As interest rates continued to rise, however, the increased interest costs consumed the remaining spread between those costs and income received on assets (primarily interest payments from borrowers on long-term fixed rate mortgage loans), triggering huge losses and a crisis in the industry. Congress again responded by easing regulatory restrictions on the industry, encouraging savings and loans to enter broader categories of business. Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469. Franklin did not use these expanded powers to speculate in commercial real estate or other risk-laden businesses; rather, it focused primarily on mortgage-related securities, which were permissible investments even before the new legislation.

record) that Franklin was in compliance with all regulatory directives and presented no risk to the federal insurance fund. Trial Exhibit 876.[4]

By 1989, despite the economic crisis afflicting the industry, Franklin's unique approach to the savings and loan business continued to achieve positive results. Franklin had increased its capital substantially during the ten years prior to the seizure, and at the time of seizure, stockholder equity was $387 million, far in excess of regulatory capital minimums.[5] App. 104a, 107a. Even after FIRREA imposed new capital standards on the thrift industry in August 1989, Franklin met all of the new standards. For example, Franklin's tangible capital exceeded the new regulatory requirement by $190 million. Trial Exhibit 624 (Franklin's Form 10Q for the quarter

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[4] For example, Franklin met the requirements set forth in Thrift Bulletin 12, which governed ownership of mortgage derivative securities, because its large capital base far exceeded regulatory minimums. Moreover, at the time of seizure, the aggregate amount of Franklin's holdings in mortgage derivatives was essentially the same as in the previous regulatory examination in which Franklin had received a highly favorable rating. App. 101a-102a. In fact, the risk profile of those securities had decreased substantially since that time, and the fair market value of those assets exceeded Franklin's cost by about $100 million. Franklin also complied with all published regulatory restrictions on the use of brokered deposits, 12 U.S.C. § 1831f; 12 C.F.R. § 337.6 (1991), and at the time of seizure its funding costs had actually decreased from the previous regulatory examination. App. 98a-99a. And finally, Franklin's hedging of its funding costs complied in all respects with the applicable rules in Thrift Bulletin 13, a fact never disputed by the regulators; the hedging issues raised by OTS dealt with the accounting for the hedge transactions and not the success of the hedging program in managing interest rate risk.

[5] In fiscal 1989, Franklin experienced substantial increases in its deferred hedging losses which resulted primarily from a huge drop in interest rates. However, the district court found that, because of Franklin's programs for creating offsetting hedges, "[n]either the level nor the amount of deferred hedging losses have been shown to create any legitimate safety or soundness concerns." App. 91a. Also, the court found that Franklin had suffered no economic loss from its hedging operations. *Id.*

ended 12/31/89). Despite the onset of the recession and a decline in earnings, Franklin's operations remained consistently profitable; it had $90 million of net interest income for the fiscal year prior to the seizure and a steady economic net interest margin for the previous five years. App. 105a.

2. Franklin's filing of its 10K annual report for the period ended June 30, 1989 prompted OTS's first adverse action against Franklin. *Id.* at 70a. This 10K contained routine "boiler plate" warnings to public shareholders about "material adverse risk" in the securities it held and the possibility of withdrawal of deposits. Although such warnings are mandatory in 10K filings, and Franklin's previous filings had included them, an OTS-Topeka analyst relied upon them as a basis for a memorandum (also excluded from the Director's "designated record") down-grading Franklin's regulatory status from healthy to marginal.[6]

During the 1989 regular examination, the OTS-Topeka office informed Franklin that a $248 million write-down of capital[7] was required because Franklin improperly accounted for certain hedging losses. *Id.* at 71a. OTS concluded that ordering such an extensive capital write-down would likely cause Franklin to be in breach of certain bond obligations and cited this as one of the

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[6] The district court noted that the author of the memorandum was Thomas O'Rourke, the analyst who had been in charge of the infamous Silverado Savings and Loan investigation. App. 70a. Shortly before OTS-Topeka turned its attention to Franklin, it had also handled the Silverado investigation. OTS-Topeka received severe criticism, both from Congress and the Administration, for its handling of that investigation—so severe that OTS Director Wall threatened the Silverado analysts with termination if their performance did not improve. *Id.* at 69a. O'Rourke, who admitted he had no experience with 10K filings, was assigned to lead the regulatory oversight of Franklin, along with several other analysts from the Silverado investigation. *Id.* at 70a.

[7] A "write-down of capital" is a reduction in the value of assets stated on Franklin's accounting ledgers.

reasons for the appointment of a conservator. As shown by evidence that the Director excluded from the designated record, OTS's expectation of a breach was unfounded; Franklin had learned from the bond trustee that no default would be declared and so informed an OTS attorney who withheld that critical fact from the Director. *Id.* at 74a-75a. Moreover, even if the OTS-imposed accounting adjustments were correct, Franklin still would have maintained compliance with all regulatory capital requirements. *Id.* at 76a. Nonetheless, a conservator was appointed on February 15, 1990 to manage all of Franklin's assets.

After the appointment, and after all the write-downs that OTS required post-seizure, the conservator (Resolution Trust Corporation) notified OTS on March 8, 1990, that it was prepared to announce publicly that Franklin had the means to meet regulatory capital requirements and was a solvent institution. *Id.* at 78a. The next day, however, OTS ordered further capital write-downs. The district court later found this "second-wave" of write-downs to be wholly without factual basis, *id.*, and an improper attempt by the agency to justify an erroneous seizure. *Id.*

3. The seizure and imposition of the conservator completely divested the Franklin shareholders of their ownership and control of the institution. The conservator assumed all of the "rights, titles, powers and privileges" of Franklin, its shareholders, officers, and directors. 12 C.F.R. § 579.2(b)(7) (1991). The conservator's broad discretionary powers over Franklin (see 12 U.S.C. § 1821 (d)(2)(I)) include the power to merge it with another institution or to transfer all of its assets, thus extinguishing its existence. 12 U.S.C. § 1821(d)(2)(G)(i).

The OTS seizure was premised on three of the statutory grounds for appointment of a conservator for a state savings association, none of which required present insolvency. 12 U.S.C. § 1464(d)(2)(C)(iii), (v), (vi). The Director's order largely parroted the statutory language with respect to safety and soundness. See app. 117a-118a.

As allowed by the statute, 12 U.S.C. § 1464(d)(2)(E), these findings were made *ex parte* and without any notice to the institution's owners or managers, who simply received a regular report containing the OTS examiners' conclusions after the savings and loan had been confiscated.

B. Procedings Before The District Court

Within 30 days of the seizure, Franklin filed an "action" seeking removal of the conservator, pursuant to § 1464(d)(2)(E). Shortly therafter the Director submitted to the district court and to Franklin a copy of his "designated record." The designated record was, as the district court observed, "a selective compilation of documents" by OTS, app. 53a, and thus consisted solely of materials carefully chosen by OTS to support its decision. The record did not even include any of the documents which Franklin had submitted to OTS in response to questions raised during the examination. Instead, the Director chose to include several agency memoranda prepared by OTS staff solely to justify the conservatorship, along with regular examination reports previously provided to Franklin and Franklin's public securities law filings. Franklin had no opportunty to participate in the compilation of the designated record or to challenge its contents. In short, the designated record told only the Director's side of the case.

At the hearing on Franklin's action before the district court, the court adopted a "hybrid" review procedure. In deference to the agency's expertise, the court rejected a *de novo* standard of review and instead adopted the familiar "arbitrary and capricious" standard from the Administrative Procedure Act, 5 U.S.C. §§ 701-06 (the "APA").[8] The court emphasized that Franklin bore the burden of persausion, app. 48a, and that " '[t]he court is not empowered to substitute its judgment for that of the

[8] The APA directly applies only where, unlike here, no "special statutory review proceeding" exists. 5 U.S.C. § 703.

agency.'" *Id.* (quoting *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 415 (1971)).

As to the scope of its review, the district court received into evidence not only the designated record but also documents and testimony relevant to the issues on the merits. The court noted that § 1464(d)(2)(E) calls for a hearing "upon the merits." In light of this plain language and of the basic requirements of due process, the district court concluded that "[t]o provide a meaningful review, the court must consider evidence outside the administrative record." App. 51a. The court reasoned that "to allow this sort of seizure of property without at least allowing plaintiffs a post-seizure opportunity to present evidence supporting their case in opposition of the conservatorship, would definitely raise serious constitutional due process concerns." *Id.*

On the merits of the Director's appointment of a conservator, the district court found in favor of Franklin as to each statutory ground and issue which OTS claimed as a basis for its seizure. The court's determination was based on "the testimony and evidence presented, . . . numerous depositions submitted by the parties and . . . the three volume administrative record compiled by OTS." App. 45a. The court observed that "[m]embers of the OTS-Topeka staff appeared to lack adequate training and understanding to evaluate the nature of Franklin's operation," *id.* at 70a, and found that the OTS-designated record "contained fundamental factual errors as well as material errors of interpretation and analysis." *Id.* at 71a. Specifically, the court concluded that Franklin's use of brokered deposits did not create the safety and soundness concerns OTS expressed, *id.* at 99a, that Franklin had managed successfully the risks connected with the mortgage derivative securities it held, *id.* at 101a-102a, and that Franklin was in full compliance with all regulatory capital requirements. *Id.* at 78a, 106a-108a. Ultimately, the court held that "no statutory ground for the imposition of a conservatorship existed and . . . OTS's action in imposing the . . . conservator lacked *any basis*

in fact and was arbitrary and capricious." *Id.* at 115a (emphasis added). The court summarized its conclusions by stating: "The facts of this case clearly show that the regulator acted wrongly in imposing the conservatorship." *Id.*

Finally, the district court explicitly acknowledged the public's concern about misconduct in the savings and loan industry. Based upon the extensive hearing record and its observations of Franklin's top officers, who appeared as witnesses, the court found this concern inapplicable to Franklin:

> [T]his is not a case involving an infamous or notorious savings and loan association, the likes of which the public has recently become more than familiar. This is not a case involving fraud, corruption, or self-dealing by the management or directors of Franklin. There has been no allegation or even hint of illegal or unethical conduct by Franklin's management or directors.

Id. at 45a (footnote omitted).

C. The Court of Appeals' Ruling

The court of appeals reversed. It ruled that the district court had erred in accepting *any* evidence from Franklin on the merits of the case. App. 18a-19a. It also held that the administrative record on appeal properly consisted not of all the documents before the agency at the time of decision, but only "the information *that he relied upon in making his decision.*" App. 18a (emphasis in original). Applying this narrow scope of review, the panel found that the Director's designated record provided "a rational basis" for the Director's "opinion" that statutory grounds existed for appointment of a conservator. App. 37a-38a.

The panel also dismissed Franklin's due process challenge. App. 17a. The panel treated the claim solely as one involving inadequate pre-deprivation process; the court simply ignored Franklin's actual challenge to the

lack of any meaningful post-deprivation process.[9] The panel concluded that its own narrowed scope of review was consistent with the requirements of due process and remanded with an order that Franklin's action be dismissed.

REASONS FOR GRANTING THE PETITION

The holding of the Tenth Circuit confers extraordinary authority upon government agencies to seize property belonging to private individuals without ever having to justify the action on the merits. No one quarrels that the federal government must have authority to act quickly and decisively whenever a financial institution poses a serious risk to the federal insurance fund. But the government's compelling interest in preventing loss through immediate action dissolves once the institution has been seized from private hands. At that point fundamental fairness requires that the individual whose property has been confiscated be given a fair opportunity to prove on the merits that the action of the regulator was arbitrary because it lacked a factual basis or was based on false assumptions.

The court of appeals denies the private parties any meaningful opportunity to be heard at any time. Instead of allowing complainants a fair hearing in which to explain to the district court why the government's decision to seize potentially hundreds of millions of dollars of shareholder equity was arbitrary and capricious, the court of appeals' ruling requires complainants to demonstrate, solely on the basis of the agency's specially prepared and selected internal memoranda, how the regulator's opinion "transgress[ed] the bounds of reason." App. 34a. This is an impossible burden, and it is a process that eviscerates the statutory right to challenge the seizure "upon

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[9] In fact, petitioners have never contended that due process compels a *prior* hearing. Rather, petitioners have always contended that, in this context, "denial of pre-deprivation procedures is not a violation of due process," but that it does "heighten[] the need for adequate post-deprivation procedures." (Petitioners' 10th Cir. Br. at 21.)

the merits" and renders the Due Process Clause a dead letter. Moreover, the Tenth Circuit has necessarily held that OTS can seize and retain a financial institution on the basis of false information. The district court found that the premises on which the Director acted were false and the court of appeals did not reject those findings as clearly erroneous.

In these circumstances, it is easy to understand why numerous federal courts have interpreted the statutory term "upon the merits" to require a meaningful post-seizure hearing in which challenging parties are given an opportunity to shape the record with their own submissions and to challenge the Director's factual claims through cross-examination. See *infra* pp. 15-17. This divergence of judicial opinion on an issue that is fundamental to the regulation of this industry warrants review by this Court. This case, in which the two lower courts reached opposite conclusions on the merits of the agency decision because of the nature of the record used for review, presents the perfect vehicle for addressing the basic scope of review question presented under 12 U.S.C. § 1464(d)(2)(E).[10]

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[10] The importance of the record in these cases is most graphically revealed by the disparity in the opinions of the two courts below concerning the officers and directors of Franklin. The district court, after seeing the individual witnesses and listening to them explain their business practices, concluded that they acted in good faith and in the best interests of the savings and loan and the federal insurance fund. The court of appeals—without reviewing the hearing record and accepting rank assertions (primarily in OTS's appellate brief)—labeled these individuals as almost criminals for "diverting millions of dollars into their pockets through large salaries, bonuses and dividends, notwithstanding the losses being incurred by the association." App. 40a. The fact that the court of appeals could be so severely misled by imposing blinders upon itself (*e.g.*, the hearing below revealed that the agency had given prior approval to all dividends), speaks volumes about the value of a full and fair hearing record in cases involving the seizure of private financial institutions, and of the value of observing demeanor in a case where witness credibility is an issue.

Review by this Court is also appropriate because the panel's decision to allow the Director free reign to designate only certain documents in the agency file as constituting the entire "agency record" conflicts with decisions of other circuits. Other courts hold that, even when review is limited to the agency record, the court must determine whether the agency's decision was arbitrary or capricious on the basis of the "whole record," not just that portion offered by the agency. As those courts have noted, allowing the agency to compose a selective record would make judicial review a "meaningless gesture" and smacks of a "hypocritical scheme" of justice.

Finally, the grave need for a uniform standard also warrants this Court's review. The problem illustrated by this case is magnified manyfold by the increasing number of regulatory seizures of financial institutions made not only by OTS, but also by the FDIC.[11] While these seizures are often necessary to protect the public fisc, the dramatic increase in their number brings with it a substantially increased risk of error. Whether or not a financial institution is given a meaningful opportunity to convince a court that an OTS or FDIC decision was arbitrary and capricious should not depend upon the jurisdiction in which it files its action.

The question presented in this case is whether the court of appeals erred in concluding that Congress, by establishing in the district courts the authority to determine the legality of seizure decisions "upon the merits," limited those courts to consideration of an agency-designated record. The question raises two distinct issues: (1)

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[11] The judicial review provision for FDIC decisions to appoint conservators or receivers for banks contains the same "upon the merits" language as § 1464(d)(2)(E). See 12 U.S.C. § 1821(c)(7). Thus, the due process concerns arising out of savings and loans seizures will arise in the course of bank seizures as well. *See also* Knight & Schmidt, *U.S. Shifts Bank, S&L Strategies*, Washington Post, Dec. 8, 1991, at A-22 (Director of OTS and Chairman of FDIC estimate that over 400 savings institutions and banks will be seized in 1992).

whether the court of appeals erred in holding that a savings association cannot offer evidence in its defense before the district court; and (2) whether the court of appeals erred in holding that review of an administrative record can be limited to agency-designated portions of that record as opposed to the full record that was before the agency when the decision was made. Both holdings conflict with the holdings of other lower courts.

1a. Considerable confusion exists among district courts concerning their obligation under § 1464(d)(2)(E) to review seizure decisions "upon the merits." The bulk of these decisions allows the savings institutions to introduce evidence at the judicial hearing. At least two other district courts expressly have applied the "hybrid" review procedure applied by the district court in this case; that is, permitting the savings association to introduce evidence rebutting OTS's statutory grounds for seizure, while also requiring the savings association to show that the seizure decision was arbitrary and capricious.

The first, *Collie* v. *FHLBB*, 642 F. Supp. 1147, 1149-52 (N.D. Ill. 1986), served as the foundation for the district court's opinion here and declared that the institution must have "a meaningful opportunity to make a case in opposition to the appointment . . . . [i]f it has not, then the court should provide that opportunity." *Id.* at 1152. The second, *Marietta Franklin Sec. Co.* v. *Muldoon*, 770 F. Supp. 1212, 1220-21 (S.D. Ohio 1991), expressed grave doubts that limiting review to the record in such cases could be consistent with due process requirements and concluded that "[a]fter a thorough review of the multitude of cases concerning the role of court review permitted within this area . . . the Court feels that the parties should be able to supplement the Administrative Record." The *Marietta* court also issued a plea for an end to the confusion that exists over the proper interpretation of § 1464(d)(2)(E):

> It has also become readily apparent that a uniform resolution is needed for these statutory sections. To the extent that this Country continues to face more

> and more failed savings associations, more and more challenges to the appointment of receivers or conservators will be maintained.

770 F. Supp. at 1221 n.8.

The District Court for the District of Columbia, which is an alternative venue for all actions under § 1462(d)(2)(E), has followed a review procedure similar to the hybrid process. In *Lincoln Sav. & Loan Ass'n* v. *Wall*, 743 F. Supp. 901, 904 n.3 (D.D.C. 1990), the court applied an arbitrary and capricious standard of review, but held that due process and the statute "require the reviewing Court to undertake a level of inquiry beyond a simple review of the administrative record." A recent decision from that same court, however, conflicts with the ruling in *Lincoln*. Relying upon the Tenth Circuit's holding in this case, the court in *Gibraltar Sav.* v. *Ryan*, 772 F. Supp. 1290, 1293 (D.D.C. 1991), held that "the scope of review must be limited to the administrative record that was before the Director at the time the decision was made to appoint a receiver."

Two more courts, including the first court to interpret § 1464(d)(2)(E) in a receivership case after the statute was amended in 1966, have utilized a review process similar to the hybrid procedure, although they have altered slightly the scope of review. See *Washington Fed. Sav. & Loan Ass'n* v. *FHLBB*, 526 F. Supp. 343, 350 & n.1 (N.D. Ohio 1981); see also *San Marino Sav. & Loan Ass'n* v. *FHLBB*, 605 F. Supp. 502, 508 (C.D. Cal. 1984). In *Washington Federal Savings*, the court reviewed the receivership appointment, but took pains to recreate the "full" administrative record and to allow the savings association an opportunity to rebut the evidence contained therein. 526 F. Supp. at 350-52 & n.2. Similarly, in *San Marino Savings*, the court applied an arbitrary and capricious standard and allowed a trial on the factual issue that the parties agreed was dispositive of the case.

Still other district courts have gone beyond the limited or "hybrid" review procedure and have interpreted § 1464

(d)(2)(E) to require *de novo* review of the Director's seizure decision. See *Fidelity Sav. & Loan Ass'n* v. *FHLBB*, 540 F. Supp. 1374, 1377 (N.D. Cal.) ("the term 'on the merits' reveals that a proceeding under this statute is more in the nature of a *de novo* review than an appellate review"), *rev'd on other grounds*, 689 F.2d 803 (9th Cir. 1982); *Telegraph Sav. & Loan Ass'n* v. *FSLIC*, 564 F. Supp. 862, 868-71 (N.D. Ill. 1981) ("That the hearing is to be 'on the merits' suggests that the plaintiff is entitled to a more expansive review than that mandated by statutes requiring hearings 'on the record'" (*id.* at 869)), *aff'd sub. nom. Telegraph Sav. & Loan Ass'n* v. *Schilling*, 703 F.2d 1019 (7th Cir. 1983). See also *Haralson* v. *FHLBB*, 721 F. Supp. 1344, 1352-54 (D.D.C. 1989) (requiring the government to make an initial showing that the seizure was valid and allowing for initial development of evidence at trial in federal court).

The two other circuit court opinions interpreting § 1464 (d)(2)(E), upon which the Tenth Circuit relies heavily, do not resolve the question presented in this case. See *Woods* v. *FHLBB*, 826 F.2d 1400, 1406 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Guaranty Sav. & Loan Ass'n* v. *FHLBB*, 794 F.2d 1339, 1342 (8th Cir. 1986). Neither court addressed the issue of a hybrid standard that gives deference to the Director's decision-making while allowing the savings association an opportunity to offer evidence in its defense; instead, they only rejected the claim that § 1464(d)(2)(E) requires a *de novo* trial. They did not hold that arbitrary and capricious review could not extend beyond a designated record. In fact, contrary to the opinion of the Tenth Circuit here (app. 13a), the *Woods* court declared that the holdings in *Collie* and *Telegraph Savings* were consistent with its own reading of § 1464(d)(2)(E) for the reason that those courts had found that the savings association had been afforded a meaningful hearing—even though that hearing was in the district court itself. 826 F.2d at 1407. The *Woods* court also recognized the constitutional due process tension inherent in an "on the

record" proceeding in circumstances in which there is a complete absence of pre-deprivation process, but held there that in that particular case review "on the record" would suffice because the institution there had had adequate opportunities to make its own record on the issues which resulted in the seizure. 826 F.2d at 1411-13.

Thus, the Tenth Circuit's interpretation—which severely truncates review of an agency-designated record, despite a complete lack of pre-deprivation process—exacerbates the confusion and conflict among the district and circuit courts on this recurring issue that implicates significant constitutional concerns. As demonstrated above, numerous district courts and circuit courts have reached different conclusions as to when and in what manner a savings association will be afforded an opportunity to offer its evidence on the merits and present its defense. The Tenth Circuit, however, stands alone in depriving the savings association of that opportunity altogether.

b. Applying basic principles of statutory construction, it is evident that the Tenth Circuit's reading of § 1464(d)(2)(E) is incorrect. First, contrary to the court of appeals' reading, see app. 11a-15a, the statute is not silent as to the scope of the district court's review: The statute calls for review "upon the merits." The Tenth Circuit, however, effectively has rewritten the statute to provide for review "on the record." Whether understood as a term of art or plain English, review "upon the merits"—like a decision or ruling "upon the merits"—denotes a full review of the substantive issues presented.

Here, the substantive issues concern the Director's obligation to defend before the district court his "opinion" that an *ex parte* appointment of a conservator is warranted based upon one or more of the six grounds specified in § 1464(d)(2)(C). In a review "upon the merits," then, the adversely affected party may contest whether such grounds existed. While principles of administrative law require deference to the Director's ex-

pertise, the chailenging party must remain free to demonstrate that the Director's reliance upon one or more of these grounds was not based upon relevant factors or was the product of a clear error of judgment. *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 416 (1971). Thus, review "upon the merits" under § 1464 (d) (2) (E) proceeds under the familiar arbitrary and capricious *standard* of review, but the plain language of the statute indicates that the *scope* of that review must be expanded to allow the challenging association an opportunity to present evidence that the statutory requirements have clearly not been satisfied.

Moreover, there is ample basis upon which to conclude that Congress recognizes a distinction between review "on the record" and review "upon the merits." Where Congress has meant to limit the scope of review of an agency action to the administrative record, it has used the phrase "on the record," which has become a term of art.[12] Even in the course of reenacting § 1464 (d) (2) (E) in its "upon the merits" form as part of FIRREA, Congress provided for "on the record" review for other agency actions taken under FIRREA. See 12 U.S.C. § 1467a (j) ("on the record" judicial review in the circuit court of appeals for OTS-imposed penalties). Thus, had Congress wanted to limit review to the "record" in § 1464 (d) (2) (E), it certainly would have used that language. As this Court has previously noted, "where Congress intends review to be confined to the administrative record, it so indicates, either expressly or by use of a term like

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[12] *E.g.*, Archaeological Resources Protection Act of 1979, 16 U.S.C. § 470ff (b) (1) (civil penalties must be supported by "substantial evidence on the record"); Tariff Act of 1930, 19 U.S.C. § 1516a (b) (duties or tariffs levied must be supported by "substantial evidence on the record"); *see also* Trade Act of 1974, 19 U.S.C. § 2395 (review of Secretary of Labor's rulings on firms relocating to foreign countries shall be upon "the record on which he based such determination"); Social Security Act, 42 U.S.C. § 405 (g) (review of benefit determinations should be "upon the pleadings and transcript of the record"). *Cf.* Food Stamp Act of 1964, 7 U.S.C. § 2023 (suit in United States district court "shall be a trial de novo").

'substantial evidence,' which has 'become a term of art to describe the basis on which an administrative record is to be judged by a reviewing court.'" *Chandler* v. *Roudebush*, 425 U.S. 840, 862 n.37 (1976) (quoting *United States* v. *Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963)).[13]

Second, the structure of the Home Owners' Loan Act, as amended by FIRREA, confirms that § 1464(d)(2)(E) should be given its plain meaning. See *K Mart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291-92 (1988). Congress' direction in the statutory language that review must occur in the district court indicates a need for the special offices of that court as a trier of fact.[14] If Congress had intended to limit judicial review to the administrative record, Congress would simply have provided for initial review on a direct petition to the court of appeals, as it

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[13] For the same reasons, the court of appeals erred in relying on *Camp* v. *Pitts*, 411 U.S. 138 (1973), and *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402 (1971). Both of those cases involved review pursuant to the APA, not a special statute. There was no issue in either case involving a statutory direction of "upon the merits" review or anything similar to that command. *Overton Park* does, however, demonstrate that even under the APA reviewing courts may be required to go beyond the administrative record:

> [S]ince the bare record may not disclose the factors that were considered or the [agency's] construction of the evidence it may be necessary for the District Court to require some explanation in order to determine if the [agency] acted within the scope of [its] authority and if the [agency's] action was justifiable under the applicable standard.

Overton Park, 401 U.S. at 420.

[14] *See Washington Fed. Sav. & Loan Ass'n* v. *FHLBB*, 526 F. Supp. 343, 350 (N.D. Ohio 1981) ("Provision for a district court action perforce allows for the calling of witnesses and the development of a factual judicial record"). As commentators have noted, "[t]he absence of a formal adjudicatory record justifies . . . a presumption in favor of district court review. Without such record, a judicial trial will very often be necessary to determine either the basis upon which the administrator acted or the facts relevant to an evaluation of his action." Currie & Goodman, *Judicial Review of Federal Administrative Action : Quest for the Optimum Forum*, 75 Colum. L. Rev. 1, 57 (1975).

has done in countless other areas.[15] This Court has noted the relationship between the intended scope of review and the court designated by Congress to conduct the initial judicial review. See *Florida Power & Light Co.* v. *Lorion*, 470 U.S. 729, 742-45 (1985) (judicial review will normally lie in the courts of appeals; district court factfinding powers could make up deficiency where "reviewing court would lack an adequate agency-compiled factual basis to evaluate the agency action"); see also *McNary* v. *Haitian Refugee Ctr., Inc.*, 111 S. Ct. 888, 898 (1991) (highlighting the significance of "the factfinding and record-developing capabilities of a federal district court" and holding that district court factfinding is essential where the challenging party has had an insufficient opportunity to develop the record below). That Congress has assigned the judicial review function to the district court, where a full and fair factual record can be compiled, compels the conclusion that it did not intend for OTS to have the power both to determine and to limit the facts through its secret, unilateral compilation of a designated record.[16]

Third, this Court has repeatedly held that, when possible, statutes should be construed to avoid constitutional difficulties. *Edward J. DeBartolo Corp.* v. *Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568, 575 (1988); *Ellis* v. *Brotherhood of Ry., Airline & S.S. Clerks*, 466 U.S. 435, 444 (1984); see also *Ashwander* v. *TVA*, 297 U.S. 288, 348-49 (1936) (Brandeis, J., concurring). The review process adopted by the Tenth Circuit in this case, however, creates a significant due process issue.

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[15] *E.g.*, 29 U.S.C. § 160(f) (NLRB); 15 U.S.C. § 45(c) (FTC); 16 U.S.C. § 825*l*(b) (FPC); *see* L. Jaffe, *Judicial Control of Administrative Action* 157 (1965). *See also* 28 U.S.C. § 2347(b) (court of appeals jurisdiction for review of certain agency actions; providing for remand to agency or transfer to district court "[w]hen the agency has not held a hearing before taking the action").

[16] The court of appeals failed to address the significance of the congressional choice that judicial review occur in the district court. In fact, in quoting the judicial review statute, the court of appeals edited out the words "United States district court." App. 11a.

This Court has held that where there is "no initial check against mistaken decisions" and the property interests at stake are substantial, an evidentiary hearing must be held before the government can conclusively terminate a legitimate claim of entitlement. See *Brock* v. *Roadway Express, Inc.*, 481 U.S. 252, 261, 263 (1987) (requiring a complete and expeditious review following minimal notice); *Goldberg* v. *Kelly*, 397 U.S. 254, 266-71 (1970) (evidentiary hearing on suspension of welfare benefits must include opportunity to confront witnesses and present evidence). Section 1464(d)(2)(E) permits the Director to appoint a conservator *ex parte* without affording the savings association *any* notice or other pre-deprivation procedural protections. The statute further authorizes appointment based solely upon the Director's "opinion" that such an appointment is necessary. As the court of appeals itself emphasized, a seizure can therefore be triggered solely by the Director's "belief held with confidence, not substantiated by direct proof or knowledge." App. 12a (quoting Webster's II, New Riverside University Dictionary (1988)). Thus, none of the usual procedural checks present in an administrative scheme, such as a hearing before an administrative law judge or an opportunity for formal comments, are available to a savings association. Where, as here, the district court hearing represents the only opportunity for the savings association to make its case in opposition to the Director's seizure, due process requires something more than a perfunctory look at documents selected from the record by the agency.[17] The expanded scope of review applied by the district court, which nonetheless gives deference to the agency's decisionmaking, satisfies this requirement.

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[17] The court of appeals' opinion itself reveals that the degree of deference it gave to the Director was both excessive and mistaken. The seizure of Franklin was based primarily upon OTS's claim that Franklin had to write down its capital because its hedge accounting procedures, as opposed to OTS's, were not con-

Finally, review "upon the merits," as undertaken by the district court here, in no sense jeopardizes the statutory and regulatory schemes embodied in HOLA and FIRREA. The district court's review takes place *while the conservator manages the assets of the savings and loan.* The only conceivable effect upon the government's interest, then, is longer hearings. This effect is amply justified given the complete deprivation of the financial interest of the savings association's owners and the fact that, as here, the district court proceeding is the only opportunity for the owners to make their case against the OTS action. Thus, the court of appeals mistakenly relied upon the broad powers granted to the OTS Director in concluding that the post-deprivation review process should be a highly circumscribed one. See app. 12a. A broader scope of review *after* appointment of a conservator would not hinder OTS's ability to take swift action to protect the public fisc. As discussed previously, numerous district courts have conducted extended inquiries and there is no evidence that the proceedings had any untoward effects on OTS's enforcement efforts.[18]

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sistent with Generally Accepted Accounting Principles ("GAAP"). *See, e.g.*, app. 37a-38a. The panel, however, held that "both competing accounting standards were in accordance with GAAP." *Id.* The conclusions that ought to follow are that the presumption of correctness the Director enjoys was thereby rebutted and that his "opinion" was the product of clear error. *See* 12 U.S.C. § 1463 (requiring capital to be measured according to GAAP). Yet, instead of realizing that the very foundation for the Director's action had been completely undercut, the panel declared that the district court "failed to give the appropriate deference to the standards specified by [the] Director." *Id.* at 38a. In effect, its holding was that even though Franklin's accounting was consistent with sound banking practice and controlling law, OTS could seize Franklin because OTS's new, never published standards were more to the Director's liking.

[18] The Tenth Circuit's review procedure is itself likely to hinder regulatory efforts. What, if any, opoprtunity an institution will have to present its case to a neutral decisionmaker will significantly affect how it responds to a routine examination. If the examination becomes the only opportunity for a "hearing," then institutions

In sum, none of the accepted means of statutory interpretation supports the Tenth Circuit's reading of § 1464's judicial review provision.[19] The confusion and error reflected in its opinion highlight the need for a uniform resolution within the federal court system of the conflicts regarding this statute.

2. This Court should also review this case because the holding below is in direct conflict with the dictates of this Court and holdings from other circuits concerning the proper contents of an administrative record where judicial review is limited to that record. Further, the court of appeals' holding violates long-established principles of due process by depriving a savings association of any meaningful opportunity to be heard.

The conflict arises from the panel's holding that when review is sought under § 1464(d)(2)(E), the Director's only obligations are to place before the district court his "designated record," that is, "the information *that he*

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necessarily will treat examinations as adversarial, thereby needlessly burdening the process.

[19] Although there is no need to look to legislative history when statutory language is clear, *see Toibb* v. *Radloff*, 111 S. Ct. 2197, 2200 (1991), the legislative history supports the view that "upon the merits" means something more than "on the record." Prior to 1966, § 1464 required an administrative hearing before the appointment of a conservator, with subsequent judicial review under the APA. Housing Act of 1954, Pub. L. No. 83-560, 68 Stat. 590, 636. In 1966, Congress eliminated the requirement for a pre-appointment administrative hearing and APA review, but inserted a provision for post-appointment "district court" review of such appointments "upon the merits." Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, 80 Stat. 1028, 1032-33. Thus, Congress made available in the district court the adjudicative hearing that had previously been required at the administrative level. *See Telegraph Sav. & Loan Ass'n* v. *FSLIC*, 564 F. Supp. 862, 869 (N.D. Ill. 1981) (Congress substituted federal district court hearing for prior hearing), *aff'd sub nom. Telegraph Sav. & Loan Ass'n* v. *Schilling*, 703 F.2d 1019 (7th Cir. 1983). With FIRREA in 1989, Congress again amended § 1464 to expand the authority of OTS to appoint conservators and receivers, but it left the language of the judicial review provision intact.

relied upon in making his decision[,] and to certify such information is accurate and complete." App. 18a (emphasis in original).[20] This Court has declared, however, that judicial review of agency decisions is to be based upon the "full" administrative record that was before the agency at the time of the decision. *Overton Park*, 401 U.S. at 420. The "full" or "whole" record consists of all documents and materials that were before the agency decision makers at the time the decision was made. *Camp* v. *Pitts*, 411 U.S. 138, 142 (1973); *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 487-88 (1951).

Following these dictates, the Ninth Circuit has declared that "[t]he 'whole' administrative record, therefore, consists of all documents and materials directly or *indirectly* considered by agency decision-makers *and includes evidence contrary to the agency's position.*" *Thompson* v. *United States Dep't of Labor*, 885 F.2d 551, 555 (9th Cir. 1989) (second emphasis added) (quoting *Exxon Corp.* v. *Department of Energy*, 91 F.R.D. 26, 33 (N.D. Tex. 1981)); *Public Power Council* v. *Johnson*, 674 F.2d 791, 794 (9th Cir. 1982). Similarly, the District of Columbia Circuit has held that "[t]he [APA] and the cases require that the complete administrative record be placed before a reviewing court." *Natural Resources Defense Council, Inc.* v. *Train*, 519 F.2d 287, 291 (D.C. Cir. 1975). The Second and Fourth Circuits also have rejected reliance upon a designated record, even if that record might have been adequate to understand the agency's rationale. See *Dopico* v. *Goldschmidt*, 687 F.2d 644, 654 (2d Cir. 1982) (vacating district court's holding that the record was "adequate to enable the Court to determine the path that the agency . . . followed" and holding that "reasoned decision-making must be judged against the record

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[20] The court of appeals did suggest that evidence outside the designated record might be received in "certain narrow circumstances." App. 19a. But the court's failure to allow an exception in this case where the evidence was clearly dispositive demonstrates that its vague reference to the availability in other cases of certain undefined exceptions is meaningless.

as a whole") (emphasis in original); *Appalachian Power Co.* v. *EPA*, 477 F.2d 495, 507 (4th Cir. 1973) ("in making its review, the Court must have, not merely [the] full articulation of the agency's reasoning, but it must also have . . . 'the full administrative record that was before the Secretary at the time he made his decision' ") (quoting *Overton Park*, 401 U.S. at 420).

These decisions are rooted in the fundamental fairness that the Due Process Clause guarantees to all persons before the government may deprive them of their property. "It has long been recognized that 'fairness can rarely be obtained by secret, one-sided determination of facts decisive of rights . . . [And n]o better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him and [an] opportunity to meet it.' " *Fuentes* v. *Shevin*, 407 U.S. 67, 81 (1972) (quoting *Joint Anti-Fascist Refugee Comm.* v. *McGrath*, 341 U.S. 123, 170-72 (1951) (Frankfurter, J., concurring)). See also *Matthews* v. *Eldridge*, 424 U.S. 319, 335 (1976); *Woods* v. *FHLBB*, 826 F.2d 1400, 1411 (5th Cir. 1987) (absence of pre-deprivation process heightens the need for post-deprivation procedures), *cert. denied*, 485 U.S. 959 (1988); *Exxon Corp.*, v. *Department of Energy*, 91 F.R.D. 26, 39 (N.D. Tex. 1981) ("It would be a hypocritical scheme indeed to hand to a decision-maker the power to control review of its decision"); *Tenneco Oil Co.* v. *Department of Energy*, 475 F. Supp. 299, 317 (D. Del. 1979) (agency "may not unilaterally determine what shall constitute the administrative record and thereby limit the scope of this Court's inquiry").

Had Franklin been the subject of an administrative agency adjudicatory action, it would have had an opportunity to present evidence proving that its practices were safe and sound. Yet, Franklin was deprived of any chance to rebut the OTS decision even with the numerous documents and responses favorable to Franklin that were already part of the administrative record. The Director excluded those documents from his "designated record"

and they were not forwarded to the court. Among them were OTS internal memoranda which call into question key factual grounds that the agency cited in justifying its seizure. The district court commented on one such memorandum (Trial Exhibit 827), dated one week prior to the seizure, which indicates that OTS was aware that its claim regarding an imminent breach of Franklin's bond obligations was incorrect. See app. 96a. Similar internal memoranda state that the amount of dividends Franklin paid was not excessive (Trial Exhibit 30), and that $85 million of capital write-down required by the OTS-Topeka office was "probably not justified" (Trial Exhibit 265 at 311). Also missing were Franklin's extensive responses to OTS directives issued during the regular examinations. See app. 52a-53a & n.5.[21] The Director's designated record merely offered his "recitations"

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[21] The Tenth Circuit feebly asserts that if a savings and loan institution "desire[s] additional information from the agency record than that presented by the director to the district court, it may request such information in accordance with the applicable rules of discovery and evidence." App. 18a. This request, however, is utterly pointless because the court's scope-of-review holding bars any evidence thus discovered from district court consideration; the unfairness here is not the refusal to reveal additional information to Franklin, rather, it is the removal of that information from the record before the district court. The Tenth Circuit's assertion also reveals its neglect of the record in this case: Much of Franklin's evidence in fact came from documents in the OTS file and from OTS staff testimony.

Nor is it the case that the normal rules of discovery and evidence would enhance the judicial review process in this context; in a related case, *Franklin Sav. Ass'n* v. *Ryan*, 922 F.2d 209, 211 (4th Cir. 1991), the Fourth Circuit vacated a district court contempt order against Director Wall for failing to answer deposition questions. The court of appeals held that the rule against probing the mental processes of an administrative officer "forecloses investigation into the methods by which a decision is reached, the matters considered, the contributing influences, or the role played by the work of others." *Id.* (quoting *Carl Zeiss Stiftung* v. *V.E.B. Carl Zeiss, Jena*, 40 F.R.D. 318, 325-26 (D.D.C. 1966), *aff'd*, 384 F.2d 979 (D.C. Cir. 1967)).

of these responses, although the regulatory directives themselves were included in full.[22]

Given the nature of the property interests involved, the risk of error in these *ex parte* appointments made solely on the basis of the Director's "opinion," and the complete lack of any significant burden upon the government in providing a reasonable post-deprivation process, the court of appeals' failure to consider, at a minimum, the whole administrative record has deprived Franklin of any meaningful opportunity to be heard in response to the government's confiscation of millions of dollars in assets. See *Matthews*, 424 U.S. at 335. It is difficult to imagine a more serious departure from fundamental notions of due process. The court of appeals' disregard for established procedures for judicial review, in a manner that threatens the due process rights of parties challenging OTS actions, warrants this Court's review.

* * *

OTS wields broad regulatory authority over savings and loan associations such as Franklin, and its most severe sanction is the appointment of a conservator or receiver to manage or liquidate these private institutions. In connection with its widely publicized efforts to reform the savings and loan industry, the government is exercising these dramatic powers now with greater frequency than ever before in the nation's history. Since OTS was created in 1989, over 600 institutions have been seized and placed in conservatorship or receivership. *Hearing before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Ur-*

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[22] Moreover, the responses "recited" by OTS focused upon specific and narrow questions concerning Franklin's banking practices raised by OTS *prior* to its decision to appoint a conservator. Because no hearing of any kind was held prior to the appointment decision, Franklin's district court action was its *only* opportunity to address OTS's broader and more fundamental claims that Franklin was in an "unsafe and unsound condition to transact business," and that there existed "no reasonable prospect for the Association's capital to be replenished." App. 118a.

ban Affairs, 102d Cong., 1st Sess. (Oct. 16, 1991) (Testimony of Timothy Ryan, OTS Director). The most recent estimates of the OTS Director and the Chairman of the FDIC indicate that as many as 170 savings and loans and 240 banks could be seized in 1992 alone.[23] Given the extent of this crisis, an increasing number of regulatory seizures will follow the pattern set here. Accordingly, the issues presented in this case are certain to recur frequently and soon. The courts, the regulators, and all financial institutions need to know what the process of judicial review will be.

But the extreme nature of the holding by itself demands this Court's attention.[24] The district court found, based on a full and fair hearing record, that when Franklin was seized it was in full compliance with regulatory standards and had significant value to its owners under approved accounting procedures. App. 103a-104a, 107a-108a. The court of appeals, on the other hand, concluded that these findings should never have been made and that the hearing should never have occurred, and adopted a review procedure that looks solely at the Director's explanation of his "opinion" on a record that only he controls, and which in this case was false and misleading. Hence, like many other cases this Court has re-

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[23] Knight & Schmidt, *U.S. Shifts Bank, S&L Strategies*, Washington Post, Dec. 8, 1991, at A-22. In addition, the risk of error in connection with these closings will be exacerbated by the new "early intervention" or "prompt corrective action" standards codified in the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, § 133, H.R. Rep. No. 407, 102d Cong., 1st Sess., 39 (Nov. 26, 1991).

[24] This case has received widespread national attention, largely condemning the agency action and the court of appeals' decision. *See, e.g.*, Crovitz, *With Lawsuits Like These, The Thrift Crisis Could Be Forever*, Wall St. J., June 5, 1991, at A-11; Editorial, *Which Franklin Savings?*, Kansas City Star, June 3, 1991, at B-6; Milligan, *Abuse of Power: How The Government Railroaded Franklin Savings*, Institutional Investor, January 1991, at 50; Editorial, *Judge, Jury and Receiver*, Wall St. J., Nov. 1, 1990, at A-22; Editorial, *Sheep and Goats*, Wall St. J., Sept. 19, 1990, at A-22.

viewed, *e.g.*, *Connecticut* v. *Doehr*, 111 S. Ct. 2105 (1991) (prejudgment attachment of real estate without prior notice or hearing), this case involves an extreme exercise of government power without adequate procedures to ensure the fairness and accuracy of the government's action. Only this Court can resolve the issues presented by the review procedure adopted by the court of appeals in this case and thereby establish in a timely fashion a uniform method of judicial review that will guarantee the minimum due process rights of those institutions in Franklin's position.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 8, 1992

APPENDICES

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

Nos. 90-3272 & 90-3281

FRANKLIN SAVINGS ASSOCIATION, a Kansas Savings & Loan Association; and FRANKLIN SAVINGS CORPORATION, a Kansas corporation, in behalf of itself and in its derivative capacity as controlling shareholder of Franklin Savings Association,

Plaintiffs-Appellees and Cross-Appellants,

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION,

Defendant-Appellant and Cross-Appellee,

and

THE UNITED STATES OF AMERICA,

Defendant-Intervenor and Cross-Appellee.

On Appeal from the United States District Court
for the District of Kansas

(D.C. No. 90-4054-S)

[Filed May 28, 1991]

Charles W. German of Stinson, Mag & Fizzell, Kansas City, Missouri (David E. Everson, Brant M. Laue, Richard F. Hunter of Stinson, Mag & Fizzell, Kansas City Missouri; Roger D. Stanton of Stinson, Mag & Fizzell, Overland Park, Kansas; Paul D. Renner of Renner & Rodman, Denver, Colorado, with him on the briefs) for Plaintiffs-Appellees and Cross-Appellants.

Kenneth J. Guido, Jr., Special Senior Counsel (Harris Weinstein, Chief Counsel; Thomas J. Segal, Associate Chief Counsel; Steven W. Dimmick, Senior Trial Attorney, with him on the briefs), Office of Thrift Supervision, Washington, D.C., for Defendant-Appellant and Cross-Appellee.

Jacob M. Lewis, Department of Justice, Washington, D.C. (Stuart M. Gerson, Assistant Attorney General, Kansas; Lee Thompson, United States Attorney, Kansas; Douglas N. Letter, Appellate Litigation Counsel, and Mark B. Stern, Appellate Staff Civil Division, Department of Justice, Washington, D.C., with him on the brief), for Department-Intervenor and Cross-Appellee.

Before MCKAY, SETH, and BRORBY, Circuit Judges.

BRORBY, Circuit Judge.

The Director of the Office of Thrift Supervision (Director) appeals the decision of the trial court ordering the removal of the director appointed conservator of Franklin Savings Association (Franklin).

BACKGROUND

A generalized and simplified overview of the facts will help reveal the parameters of this litigation.

Franklin is a state chartered, stock savings and loan association that has been doing business since 1889 in

Ottawa, Kansas. Franklin has functioned during most of its existences as a traditional savings and loan association, accepting its depositors' money and in turn loaning these funds to borrowers. Loans were usually secured by a first mortgage on residential real estate. Franklin's profits were derived from the difference in interest paid to depositors and that collected from its borrowers.

In 1973, Franklin was acquired by new ownership who set it upon an expansion course. Franklin now has eight branches, all located in eastern Kansas. In addition, Franklin went "public" with approximately six per cent of its stock being publicly traded on NASDAQ.

In 1981, Franklin decided to adopt "innovative operating strateg[ies]" and "nontraditional" pursuits. Over the next eight years its deposits grew from $200 million to over $11 billion, bringing marked changes to the institution.

Franklin's asset base changed as it had acquired numerous forms of mortgage-backed securities.[1] This resulted in a volatile income stream. Franklin attempted both to predict the swings in its income stream with computer modeling, and to hedge its risks using additional and various forms of mortgage-backed securities. The securities bought and sold by Franklin included deep discounted securities, reverse repurchase agreements, long call and put options and strips (both interest only and principal only). Derivative securities (referred to by the district court as "TB 12 assets") entitle the holder to receive only part of the mortgage payments. Such securities are both higher risk and complex, and have only a thin secondary market. Franklin also began acquiring high-yield, non-investment grade bonds, commonly known as junk bonds.

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[1] A mortgage-backed security is a security that entitles the holder to share in the payments (cash flow) from a fixed pool of mortgage loans.

Ultimately, mortgage-backed derivative securities and junk bonds comprised over thirty-five per cent of Franklin's total assets. In addition, Franklin had entered into several off-balance sheet transactions of the same type. Director identified these and other concerns in the form of a supervisory directive issued to Franklin. The underlying basis for Director's concern was the fact these assets were extremely sensitive to both interest rates and principal repayments. Director was also concerned about the liquidity (the ability to immediately turn the assets into cash), as necessary to pay depositors. Director's primary concern was the level of concentration of these assets, i.e., over thirty-five per cent of Franklin's total asset base.

Franklin's liabilities likewise underwent significant changes. Franklin began soliciting deposits nationwide through the use of brokered deposits. These deposits were typically short term and of high cost to Franklin. By the end of 1989, over seventy per cent of Franklin's deposits were brokered. To attract these deposits Franklin had to pay a higher than normal interest rate for a typical savings and loan and, as the deposits were short term, it had to be in a position to turn assets quickly into cash in order to pay depositors as their deposits matured. Director repeatedly expressed his concerns in regard to the extensive use of and significant reliance upon brokered deposits. In November 1989, Director specifically expressed his concern that Franklin's use of brokered deposits had increased significantly over the last six months, both in dollar amount and in relation to total deposits; again Director's primary concern being the level of concentration of these brokered deposits, i.e., over seventy per cent of Franklin's deposits were brokered.

Franklin's position in regard to its concentration of depositors' funds in these high-risk securities was simple. It maintained that it was accurately predicting the performance of these assets; that a market did exist for

these assets; and that it had been shrinking the amount of these assets. Concerning its reliance upon brokered deposits, Franklin maintained that the costs of funds had nothing to do with the investments it acquired and that the cost of these funds was actually less than the cost of normal deposits.

Franklin's earnings were declining. Franklin's net interest margin began declining from over two per cent of its total assets in 1984 to less than one per cent by mid-1989. In the fifteen-month period ending December 31, 1989, Franklin had a loss in excess of $58 million. In August and September of 1989, while the assets were growing by $680 million, the tangible capital decreased by nearly $13 million. Earnings are an important source of capital, and Franklin's prospects of future profit appeared bleak. Director felt Franklin was facing losses in excess of $100 million for its improper deferral of hedging losses; incurred a $47 million loss in connection with letters of credit; and suffered a $185 million potential loss in connection with bonds Franklin had issued. Director again expressed his concerns to Franklin in November 1989, additionally pointing out that in the fiscal year ended June 30, 1989, Franklin paid its eight executive officers $3.5 million ($1.8 million of which was in bonuses) and paid dividends of approximately $15 million. This was done notwithstanding the fact Franklin itself reported a $9 million loss in that same fiscal year. These expenditures further impaired Franklin's earnings.

Director had many concerns about Franklin's capital structure. Franklin had unsuccessfully attempted to raise new outside capital. Franklin had also issued a significant amount of its letters of credit guaranteeing the payment of various bond issues that had originated with land developers. (Franklin euphemistically entitled this a "credit enhancement program.") Director ordered a write-down of capital in the amount of $47 million to reflect the risk associated with this credit program. Frank-

lin used accounting methods to defer its actual cash hedging losses. Director ordered an additional write-down of $9 million in order for Franklin's books to accurately reflect these losses. Franklin had issued a significant amount of its own bonds ($3 billion) and Director also ordered a write-down of $185 million to reflect a possible exposure to a perceived risk of possible default. Director believed such a write-down was necessary to avoid a default in these bonds. Director had expressed these concerns to Franklin by pointing out that Franklin's net interest margin had been shrinking and in fact was negative for the past three quarters. Director criticized Franklin's recent continued, aggressive growth in light of these facts. To understand the significance of these facts, it is important to realize that both prudence and the law demand the owner of a financial institution invest some of his own assets in the institution. While capital requirements are complex and involve many factors, we will attempt to explain this requirement with the following illustration: When $100 is accepted in deposits, the owner must have $6 *of his own assets* in the institution as capital. The bottom line in this case was simple—Franklin was intentionally and aggressively growing without a corresponding growth in capital. In fact, Franklin's capital was shrinking. Moreover, Director had repeatedly and explicitly expressed to Franklin his concern with these matters.

Franklin's position concerning the write-downs ordered by Director is that they were unnecessary as the risks identified by Director did not exist.

By mid-1989, Franklin's metamorphosis was complete. It had been transformed from a traditional savings and loan into something totally different. On June 30, 1989, Franklin's business consisted primarily of attracting savings deposits from the general public nationwide and investing these funds in various mortgage derivative prod-

ucts and mortgage-related assets. Over eighty-three per cent of its interest-earning assets were designated as "assets held for sale." Only 3.3 per cent of its total assets were contained in its loan portfolio. Franklin began to resemble a securities trading firm rather than a traditional savings and loan association.

Such a characterization is not a surprise to Franklin. Director had conducted various examinations and special audits during which there had been numerous meetings, telephone calls, and correspondence between Director and Franklin relating to the numerous problems found by Director. Director had also issued specific directives to Franklin to deal with these concerns but Franklin was either unable or unwilling to comply with the directives.

On February 15, 1990, Director, apparently deciding the failure to address his concerns must be remedied, made specific findings. These findings were based upon three volumes of documents that included reports of examinations, monthly, quarterly and annual financial reports filed by Franklin, supervisory directives, other required annual reports, and the results of an independent audit. These findings included the following:

> [Franklin] is in an unsafe and unsound condition to transact business in that, among other things, [Franklin] has a significant level of high risk assets, and has placed undue reliance on brokered deposits, (b) [Franklin] has incurred and is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for [Franklin]'s capital to be replenished without Federal assistance, and (c) there is a violation or violations of laws or regulations, or an unsafe or unsound practice or condition which is likely to cause insolvency or substantial dissipation of asse's or earnings or is likely to weaken the condition of [Franklin] or

> otherwise seriously prejudice the interests of its depositors . . . .

Director thereupon proceeded to appoint "not for the purpose of liquidation" the Resolution Trust Corporation as conservator for Franklin.

Proceedings in District Court

Franklin promptly filed an action pursuant to 12 U.S.C. § 1464(d)(2)(E) asking that Director be required to remove the conservator.[2] This complaint alleged, inter alia, the absence of the statutory grounds for the appointment of a conservator and asserted the regulatory action was arbitrary and capricious. Director filed a copy of the administrative record contending the trial court's review was limited to this record in accordance with the principles of administrative law.

The trial court rejected Director's approach and crafted a hybrid standard of review. *Franklin Sav. Ass'n v. Director of Office of Thrift Supervision*, 742 F. Supp. 1089 (D. Kan. 1990) ("*Franklin II*").[3] The trial court, citing *Collie v. FHLBB*, 642 F. Supp. 1147 (N.D. Ill. 1986), decided Franklin should have the opportunity to submit evidence outside the administrative record as to

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[2] The plain language of this statute limits those who may request relief from action taken to the association. We note the appearance, as a party, of Franklin Savings Corporation, which is the holding company of Franklin Savings Association. The parties have not raised this issue, and as it is not necessary to our decision, we decline to address it.

[3] The decision of the district court, ruling upon the motions for summary judgment in this case, is published in *Franklin Sav. Ass'n v. Director of Office of Thrift Supervision*, 740 F. Supp. 1535 (D. Kan. 1990). The district court's later ruling upon the standard of review and merits of the case is found at 742 F. Supp. 1089 (D. Kan. 1990). This later decision will be referred to as *Franklin II*.

Throughout this opinion, when referring to the district court's opinion in *Franklin II*, we will cite to paragraph numbers when provided in that opinion.

"whether or not that evidence was considered" by Director, and "to develop any facts bearing on the question of whether any of the statutory grounds existed." *Franklin II* at 1097. After reviewing the administrative record and the evidence presented to it by both Franklin and Director during an eighteen-day bench trial, the district court viewed the entire package of evidence to determine whether Franklin had overcome the presumption of correctness afforded the agency's action. The trial court correctly noted this would require Franklin to show by a preponderance of the evidence that the agency's decision "lacked any basis in fact or law or was arbitrary, capricious, or an abuse of discretion." *Franklin II* at 1096.

The trial court characterized this case as "a dispute over accounting practices," *Franklin II* at 1094, and heard numerous expert witnesses. While difficult to summarily describe the basis of the trial court's conclusions, it appears the court was more impressed with Franklin's expert witnesses than those of Director, consequently accepting the testimony advanced by those witnesses and rejecting the testimony advanced by Director's experts. In so doing, the trial court found Director "lacked any factual basis which would justify its appointment of a conservator" and further concluded Director "acted arbitrarily and capriciously in appointing the conservator." *Franklin II* at 1126. The trial court ordered Director to remove the conservator, an order which this court stayed and from which this appeal ensues.

I.

Scope of Review

Director contends the trial court should have reviewed Director's decision to appoint a conservator upon the basis of the administrative record and in accordance with the Administrative Procedure Act ("APA"). Franklin contends, however, the expanded hybrid scope of review, as

fashioned by the trial court, was correct. Whether the trial court properly limited the scope of review is a question of law, which we review de novo.

For the sake of clarity, we deal separately with the scope of review and the standard of review. The scope of judicial review refers merely to the evidence the reviewing court will examine in reviewing an agency decision. The standard of judicial review refers to how the reviewing court will examine that evidence.

We must first define the proper scope of review for a reviewing court when it reviews a director's decision to appoint a conservator for a savings and loan association. While FIRREA[4] expressly provides the authority for the director to appoint a conservator, we must examine whether Congress also established or defined the scope of review to be employed when reviewing appointment decisions. FIRREA was Congress's response to the many significant problems existing within the savings and loan industry. These problems include poor management by the owners of the thrifts; poor underwriting and loan administration standards; inadequate supervision of the thrifts by the regulators; and reliance on brokered deposits or other highly volatile sources of funds. H.R. Rep. No. 10154(I), at 299-301 (1989). Congress recognized the nation was and is facing a crisis in the thrift industry and consequently FIRREA dictates strong and prompt supervisory oversight. *Id.* at 307-308.

FIRREA creates the Office of Thrift Supervision and the position of a director. The director is given extremely broad regulatory powers as he is required to "provide for the examination, safe and sound operation, and regulation of savings associations." 12 U.S.C. § 1463 (a)(1). FIRREA likewise gives the director very broad enforce-

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[4] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183-553 (1989) (codified at 12 U.S.C. § 1461 et seq.)

ment powers including the power to appoint a conservator if "in the opinion of the Director" a statutory ground for appointment exists. 12 U.S.C. § 1464(d)(2)(E).

The pertinent portions of 12 U.S.C. § 1464(d)(2)(E) provide:

> The Director shall have exclusive power and jurisdiction to appoint a conservator. . . . If, in the opinion of the Director, a ground for the appointment of a conservator . . . exists, the Director is authorized to appoint ex parte and without notice a conservator. . . . In the event of such appointment, the association may . . . bring an action . . . for an order requiring the Director to remove such conservator . . . , and the court shall upon the merits dismiss such action or direct the Director to remove such conservator . . . .

The plain language of this statute reveals: (1) the director has the exclusive power to appoint a conservator; (2) the director may appoint a conservator if, in his opinion, a statutory ground for the appointment exists; (3) assuming the director has opined the ground for the appointment of a conservator does exist, his decision whether to appoint a conservator is discretionary; and (4) the statute, while clearly authorizing judicial review of the director's decision, fails to specifically define the scope of that review.[5]

We first emphasize FIRREA establishes that the determination of whether the statutory grounds to appoint a conservator exist lies in the province of the *director's*

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[5] The Fifth and Eighth Circuits have reached this same conclusion that the language "upon the merits" in a statute does not define the scope of judicial review. These courts have found the absence of a scope of review when examining identical language (i.e., requiring a court to review action of appointing receiver "upon the merits") used in the Home Owner's Loan Act of 1933, 12 U.S.C. § 1461 et seq. *See Woods v. FHLBB*, 826 F.2d 1400, 1406 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Guaranty Sav. & Loan Ass'n v. FHLBB*, 794 F.2d 1339, 1342 (8th Cir. 1986).

opinion. The plain, ordinary, and usual meaning of the word "opinion" is a belief held with confidence, not substantiated by direct proof or knowledge. *See* Webster's II, New Riverside University Dictionary (1988). An opinion is formed after an evaluation of the facts based upon special knowledge and expertise. Congress did not mandate a hearing or specific findings of fact be made; rather, it required only the director be of the opinion statutory grounds for appointment of a conservator exist. There exist compelling reasons for this statutory provision: A savings association's assets consist principally of its depositors' funds; assets can be quickly dissipated; liabilities may be just as quickly created; and liquidity may suddenly disappear. If there is inadequate capital to absorb losses, the losses fall upon the FDIC, and if these funds are depleted, then upon taxpayers. For these reasons, Congress made clear it expects the director to be vigilant and responsive. FIRREA's statutory scheme, the specific statute at issue (12 U.S.C. § 1464(d)(2)(E)), and the legislative history, all agree it is essential the director act promptly in appointing a conservator once he is of the opinion that a statutory ground exists. The close supervision, broad discretion, and quick response directed by FIRREA dictates a narrow and limited scope of review that gives deference to the director's judgement, knowledge, and expertise.

In cases where Congress has provided for judicial review without setting forth the standards to be used or procedures to be followed in conducting that review, the Supreme Court has advised such review shall be confined to the administrative record and, in most instances,[6] no de novo proceedings may be had. *Camp v. Pitts*, 411 U.S. 138, 142 (1973); *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 419-20 (1971); *United States v.*

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[6] We discuss 5 U.S.C. § 706(2)(F) *infra* at 25-26 n.7, which provides for de novo review in certain limited circumstances.

Carlo Bianchi & Co., 373 U.S. 709, 715 (1963); *Woods*, 826 F.2d at 1406; *Guaranty Sav.*, 794 F.2d at 1342.

A reviewing court may go outside of the administrative record only for limited purposes. For example: Where the administrative record fails to disclose the factors considered by the agency, a reviewing court may require additional findings or testimony from agency officials to determine if the action was justified, *Overton*, 401 U.S. at 420; or where necessary for background information or for determining whether the agency considered all relevant factors including evidence contrary to the agency's position, *Thompson v. United States Dept. of Labor*, 885 F.2d 551, 555 (9th Cir. 1989); or where necessary to explain technical terms or complex subject matter involved in the action, *Animal Defense Council v. Hodel*, 867 F.2d 1244, 1244 (9th Cir. 1989), and *Animal Defense Council v. Hodel*, 840 F.2d 1432, 1436 (9th Cir. 1988).

Franklin cites numerous district court cases that it contends should persuade us to interpret § 1464(d)(2)(E) as requiring either a hybrid scope of review, as was adopted by the trial court, or some other form of an expanded scope of review. For instance, Franklin cites *Haralson v. FHLBB*, 655 F. Supp. 1550, 1557-58 (D. D.C. 1987), where the court in interpreting the former, nearly identical statutory provision of the Home Owner's Loan Act of 1933, 12 U.S.C. § 1464(d)(6)(A), acknowledged that as long as a post-deprivation hearing is provided, there will be no due process violation; and *Collie*, 642 F. Supp. at 1152, where the court held that under the former but nearly identical law, the savings and loan association had the right to a meaningful opportunity at some point to make its case in opposition to the appointment. *Collie*, the case embraced and adopted by the trial court in the case before us, and other cases of similar nature, were discussed and analyzed by the Fifth Circuit in *Woods*, 826 F.2d at 1406-08, where the court found the analysis employed in these cases unpersuasive. In

Woods, the court held the "upon the merits" language of § 1464(d)(6)(A) did not require a full adversarial and evidentiary hearing, nor did it mandate de novo review of appointment decisions made pursuant to the statute. *See also Carlo Bianchi*, 373 U.S. at 715; *Guaranty Sav.*, 794 F.2d at 1342. Rather, the court held such decisions are to be reviewed on the basis of the administrative record and in accordance with the APA. *Woods*, 826 F.2d at 1408. We agree with the Fifth Circuit's decision in *Woods*, and are equally unpersuaded by *Collie* and the other district court decisions holding otherwise.

We therefore find the district court erred in adopting the reasoning set forth in *Collie*, 642 F. Supp. at 1150-52, and deciding the phrase "upon the merits," as used in § 1464(d)(6)(A), directed something more than a review of the administrative record in accordance with the APA. *Franklin II*, 742 F. Supp. at 1096-97. Review "upon the merits" simply means the district court's decision to either dismiss the action or remove the conservator should be based upon the merits of the action (i.e., whether statutory grounds for the appointments of a conservator exist), rather than on procedural or policy oriented grounds. *See Guaranty Sav.*, 794 F.2d at 1342. Again, we conclude the proper scope of review for appointment decisions made pursuant to § 1464(d)(6)(A) is that review be confined to the administrative record in accordance with the APA.

Franklin argues the Supreme Court's decision in *Overton* dictates an expanded scope of review. *Overton* revolved around a statutory prohibition against building highways through a public park where a feasible and prudent alternate route exists. The Secretary authorized the construction of a six-lane highway through a public park. The Secretary failed to make any factual findings as to why he believed there was no feasible and prudent alternate route. The Supreme Court held formal findings were not required. *Overton*, 401 U.S. at 419. The Court

further held: the Secretary's decision was subject to judicial review; de novo review was not required; the Secretary's decision need not meet the substantial evidence test; and the applicable standards of § 706 of the APA require the reviewing court "to engage in a substantial inquiry." *Overton*, 401 U.S. at 415. In *Overton*, the lower court's review was based upon litigation affidavits. As the Supreme Court found this to be an inadequate basis, it remanded with instructions that the district court could require the administrative officials who participated in the decision to give testimony or require the Secretary to make formal findings explaining the action taken. *Overton*, 401 U.S. at 420. We believe *Overton* is thus distinguishable and does not dictate an expanded scope of review.

In the case before us, Director did make formal findings and produced and certified a voluminous and detailed agency record for review that would enable the reviewing court to conduct a substantial and meaningful review from the agency record. The trial court, however, determined the three-volume administrative record, as designated by Director, was not the "whole administrative record" since it believed there were missing documents upon which Director relied. *Franklin II* at 1098. The appropriate remedy for this alleged defect would have been for the trial court to call for any missing documents or require Director to testify or provide further explanation. Instead, the district court crafted and conducted a hybrid scope of de novo review. While the director has an obligation to produce for judicial review a designated administrative record, such record does not have to be needlessly elaborate, nor as detailed as the district court here required.

For example, while the November 1989 supervisory directive issued to Franklin states merely that Franklin has increased its reliance on brokered deposits to an unacceptable level, there exist many other references in the agency

record condemning Franklin's excessive use of brokered funds. It is certainly not necessary for the administrative record to contain extensive treatment on the use of brokered funds, their pros and cons, and what levels are excessive. Such information is common knowledge to those in the banking industry. To the extent the specific material was considered by Director and not included in the agency file, the proper approach is to call for the production of such documents or require further testimony relating thereto. In the instant case, there were numerous meetings between personnel of both Director and Franklin. The trial court determined, as there were no notations as to issues discussed, Franklin's positions on these issues, or as to statements made at the meetings, the record was incomplete and therefore defective. *Franklin II* at 1096. This determination is simply incorrect. As a practical matter, the director reviews certain selected materials. Ordinarily, these materials will include: the required reports submitted by the savings association; the reports of examination; the reports of independent auditors; supervisory directories; the responses by the savings association; and such additional information as desired by the director. To require the director have reviewed and relied on all working papers, synopses of all conversations, and other minutiae, would defeat FIRREA's objective requirement of prompt supervisory action. The director need review only such information as he deems necessary or desirable to enable him to arrive at an informed and fair opinion. Absent extraordinary circumstances, the decision of the director as to what information he must review to make an appointment decision should be left to his discretion. The director, in the case of judicial review of his appointment decision, has the obligation to produce and certify the record upon which he relied at the time of the decision. This record must contain sufficient data to allow the reviewing court to determine whether the director had a rational basis for the appointment decision. In the case

before us, the administrative record contained voluminous data including: the executive summary; legal memorandum; Director's orders; state commissioner's letters; recommendation memorandum; interim reports of examination; reports of examination; supervisory reports; supervisory directives; the June 30, 1989 independent audit; the 10-K annual report for the year ended June 30, 1989; and many further reports, analyses and documents. This record was adequate to permit meaningful judicial review.

Franklin argues the agency record is one-sided and fails to contain any of Franklin's documents showing their analysis. Franklin contends these factors dictate an expanded scope of review. In making these assertions, Franklin ignores the substance of the agency record, which contains numerous recitations of Franklin's views and reasons therefor. A reading of the administrative record clearly shows the substance of Franklin's positions were before Director when the appointment decision was made. The director is not required to review every document arguably related to the troubled institution in question, nor is a reviewing court. We note again the administrative record in the instant case is extensive. The record shows Franklin had numerous opportunities to present its views and that those views were considered by Director. Moreover, the record provides ample support for Director's appointment decision.

Franklin also objects to the lack of a prior hearing. 12 U.S.C. § 1464(d)(2)(E) affords the association to which a conservator has been appointed the opportunity for judicial review of the appointment decision. The availability of this post-deprivation hearing precludes any due process violations. *See Franklin II* at 1126; *Haralson v. FHLBB*, 837 F.2d 1123, 1126 (D.C. Cir. 1988). Thus, we find Franklin has no basis to claim a constitutional deprivation on this ground.

In summary, we conclude the district court, in reviewing the director's decision to appoint a conservator, should

confine its review to that information before the director at the time the appointment decision was made. When the director learns the appointment decision has been challenged, the director has the obligation to produce the information *that he relied upon in making his decision* to the district court and to certify such information is accurate and complete. Thus, the director's obligation does not extend to *all* information contained in his files. Should the savings and loan association challenging the appointment decision desire additional information from the agency record than that presented by the director to the district court, it may request such information in accordance with the applicable rules of discovery and evidence.

Our conclusion in this case is bolstered by the overall regulatory scheme involved and the nature of the controversy. The regulatory scheme requires the financial institution submit periodic reports to the director. These reports present a balance sheet, a profit and loss statement, and other detailed financial information. The director performs periodic examinations, which in part are designed to assure the accuracy of the financial information submitted by the financial institution. In other words, the regulatory system is designed to assure a high degree of reliability in the raw data or books of account. In the controversy before us neither party has disputed the accuracy of the basic data. For example, neither the amount of total deposits nor the amount of the brokered deposits are in dispute. It is only basic policy decisions, such as whether the degree of Franklin's reliance upon brokered deposits constitutes an unsafe or unsound practice, that are now being disputed.

In summary, the statutory scheme, the legislative history, the APA, the applicable case law, and the regulatory scheme all lead us to the conclusion that when a court reviews the director's decision to appoint a conservator for a savings and loan association, the reviewing

court should ordinarily confine its review to that information that was before the director at the time the appointment decision was made.

By our holding today, we do not place any strict limitations on the admission of other evidence in certain narrow circumstances. However, such evidence should be received with caution. In addition, of the narrow exceptions to the general rule that do exist, none is applicable to the present case.

The focus of the judicial review is to determine whether there exists sufficient evidence in the administrative record to form a reasoned opinion that the statutory grounds for the appointment of a conservator exists. In this case, the district court heard live testimony from twenty-five witnesses; accepted deposition testimony from eighteen witnesses; received over 650 trial exhibits; engaged in credibility determinations regarding competing experts; and basically made its own findings, compared those to the findings of Director, and decided the conservator was wrongly appointed. Such a review was far beyond the court's permissible scope of review. We therefore find the district court erred in improperly expanding the scope of its review.

II.

Standard of Review

Having defined the applicable scope of review, we must next determine the standard of review to be applied by the district court. *See* 12 U.S.C. § 1464(d)(2)(E).

As 12 U.S.C. § 1464(d)(2)(E) fails to define or specify the standard of review to be used in examining Director's appointment decision, we look to the APA for guidance. 5 U.S.C. § 706(2)(A) of the APA directs the reviewing court to use the arbitrary or capricious standard of review. 5 U.S.C. § 701 of the APA provides the action of "each authority" of the government of the United States

is subject to judicial review except where there exists a statutory prohibition on review, or where "agency action is committed to agency discretion by law." In the case before us, the statute that gives the director authority to appoint a conservator, 12 U.S.C. § 1464(d)(2)(E), also provides for judicial review. Congress intended for the courts to review whether the facts relied on by the director show a statutory ground for the appointment to exist. We note that once a director has determined statutory grounds for the appointment of a conservator exist, the decision whether to appoint is within his discretion. However, this is not the question before the court today. What is before this court is the question: What is the standard of judicial review once the decision to appoint a conservator is made by the director, and thereafter challenged by the savings and loan association?

Here, Franklin challenged Director's decision to appoint a conservator in accordance with 12 U.S.C. § 1464(d)(2)(E). A court reviews the director's decision based upon the record before the director at the time of his decision. In conducting this review, the director's findings are entitled to deference, and the appointment decision itself is entitled to a presumption of regularity. *Overton*, 401 U.S. at 415. Franklin has the burden to overcome these presumptions. *See Guaranty Sav.*, 794 F.2d at 1342.

We believe it significant to note the case before us does not involve the more severe decision to appoint a conservator for the purpose of liquidation. Indeed, a conservator ordinarily acts as a guardian or a protector. The decision to appoint a conservator is not a judgment to divest the owner of his property. Rather, it is a judgment that the owner is unable or unwilling to properly manage or control the assets and it is an attempt to put the institution back into a safe and sound condition. H.R. Rep. No. 101-54(I), at 126, 211. This fact permits both a restricted scope of review and a deferential standard of review.

Two other circuits have addressed the standard of judicial review under the Home Owner's Loan Act of 1933, 12 U.S.C. §§ 1461-1468, which contained virtually identical statutory language as that in the present 12 U.S.C. 1464(d)(6)(A). In *Woods*, 826 F.2d 1400, the Fifth Circuit looked at the "strong congressional intent for swift, effective regulatory action" mandated by 12 U.S.C. § 1464(d)(6)(A), *id.* at 1407, and held the appointment decision must be reviewed on the basis of the administrative record in accordance with the APA's arbitrary or capricious standard of review. 5 U.S.C. § 706(2)(A).[7] In *Guaranty Sav.*, 794 F.2d at 1342, the Eighth Circuit also concluded the agency decision should be reviewed applying the arbitrary or capricious standard set forth in 5 U.S.C. § 706(2)(A) of the APA. We are persuaded by the analysis employed in these decisions and believe it is applicable to FIRREA and, therefore, to the case before us.

In sum, we conclude and hold: (1) the scope of review is ordinarily limited to the agency record before the di-

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[7] 5 U.S.C. § 706(2)(F) of the APA has been interpreted as authorizing de novo review in two instances: (1) when the action is adjudicatory in nature and the agency's fact-finding procedures inadequate; and (2) when issues not previously before the agency are raised in a proceeding to *enforce* a nonadjudicatory action. *Overton*, 401 U.S. at 415. However, neither situation exists in the case before us. Congress does not require the director to hold a hearing when making a determination as to whether a statutory ground for appointment exists; rather, the intent of Congress was to entrust the director with a vast amount of control and authority in regulating the savings and loan associations. *See Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 159-67 (1982); *Woods*, 826 F.2d at 1406; *Alliance Fed. Sav. & Loan Ass'n v. FHLBB*, 782 F.2d 490, 493 (5th Cir. 1986). We find the actions of Director in this case were made with adequate factual support, which was included in the administrative record. *See Camp*, 411 U.S. at 141-42 (fact-finding procedures used by Comptroller of the Currency not deficient). The second situation described in § 706(2)(F) clearly does not apply as the proceeding in the instant case was not brought to enforce Director's action but to nullify it.

rector at the time he made his decision to appoint a conservator; and (2) the standard of review to be utilized is that specified by the APA in 5 U.S.C. § 706(2)(A) that an appointment decision may be set aside only if the decision was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

While the district court articulated the standard of judicial review correctly, its actions in applying this standard resulted in error as it in fact applied a de novo review. We now turn our attention to this matter.

III

Review of Director's Decision

On appeal from a district court's review of an agency action, the appellate court " 'must render an independent decision on the basis of the same administrative record as that before the district court; the identical standard of review is employed at both levels; and once appealed, the decision of the district court is afforded no particular deference.' " *Webb v. Hodel*, 878 F.2d 1252, 1254 (10th Cir. 1989) (quoting *Brown v. United States Dept. of Interior*, 679 F.2d 747, 748-49 (8th Cir. 1982) (citations omitted)). As we have discussed, review of the appointment decision is governed by the APA. 5 U.S.C. §§ 701-706. Accordingly, we must uphold the agency's actions, findings, and conclusions unless they are: outside the agency's statutory authority; unsupported by substantial evidence; found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; contrary to a constitutional right or privilege; without observance of required procedure; or unwarranted by the facts to the extent the facts are subject to a trial de novo by the reviewing court. 5 U.S.C. § 706(2)(A)-(F). A reviewing court may not substitute its judgment for that of the agency. *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983).

Franklin urges us to apply a clearly erroneous standard to the factual findings of the district court. This we decline to do. We review the agency action based on the same file and under the same standard as was proper for the district court. We further decline to apply the clearly erroneous standard to findings of the district court as we have decided the district court improperly exceeded its permissible scope of review. We feel compelled to observe that Franklin has consistently misunderstood that the fact finder in this case is Director and not the district court. It is to Director's findings that some deference is due and not to those later made by the district court.

As we have held, the trial court failed to confine its review to the agency record and failed to apply the proper standard of review. In view of the fact that our task as an appellate court is essentially the same as the district court's, we will proceed to review the agency record. We believe little would be accomplished at this point by a remand to the district court.

Our review commences with an examination of the statutory grounds for the appointment of a conservator. 12 U.S.C. § 1464(d)(2)(A) sets forth at least eight separate grounds for the appointment of a conservator. In the instant case, Director found three of these grounds exist. We will examine each of these three grounds separately, although a determination that Director correctly found the existence of any one of the three statutory grounds is sufficient to uphold Director's appointment decision.

A. *Unsafe and Unsound Condition*

The first statutory ground Director found to exist was 12 U.S.C. § 1464(d)(2)(A)(iii), which is "an unsafe or unsound condition to transact business including having substantially insufficient capital or otherwise."

Director found this circumstance to exist based on, among other things, Franklin's significant level of high-risk assets and its undue reliance on brokered deposits.

We turn our attention to the administrative record to search for evidence regarding Franklin's level of high-risk assets. We quote a portion of the voluminous data bearing on this subject:

> [A] significant portion of the Association's asset portfolio is comprised of high risk assets such as principal-only and interest-only strips of mortgage backed securities, residuals of collateralized mortgage obligations ("CMO") and real estate mortgage investment conduits planned amortization classes and targeted amortization classes of the CMO, and other high-risk derivative products . . . . These assets are subject to extreme price volatility, interest rate risk, as well as significant prepayment risk. As of January 9, 1990, the Association had High Risk Assets totaling $3,715,617,000, or 40.15% of total assets.
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> . . . [B]ecause of the Association's tight interest margin, the Association will experience significant losses with respect to these High Risk Assets irrespective of whether interest rates increase or decrease. In addition, the prepayment risk cannot be hedged against with any certainty because it is affected by factors other than rising or falling interest rates, and many of the assets are keyed to varying speeds of prepayment.
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> . . . [B]ecause the Association is considered a "primary market maker" in the residuals market, the Association may be unable to successfully liquidate its investments in the High Risk Assets in the event of a thin market. Therefore the Association's High Risk Assets are subject to significant liquidity risk due to the lack of an adequate secondary market. The Association's significant level of High Risk As-

> sets thus places it in an unsafe and unsound condition to transact business.[8]

After hearing the evidence presented at trial, the district court arrived at the following conclusions regarding Franklin's significant level of high-risk assets: (1) through the efforts of Franklin's management the sensitivity to interest rate risk and prepayment risk had declined and was anticipated to decline further, *Franklin II* at ¶ 183; (2) markets exist for these high-risk assets as Franklin purchased them from dealers, *id.* at ¶ 185; (3) Director's criticism about the level of these high-risk assets was "inappropriate" because Franklin is reducing the amount of these high-risk assets, *id.* at ¶ 186; and (4) Franklin was properly monitoring and managing these assets, *id.* at ¶ 187.

The district court failed to understand the significance of Director's concerns. Director's primary concerns involved the fact that Franklin's assets were not sufficiently diversified, and far too high a concentration of its assets existed in high-risk securities. Director opined this was undesirable as the markets were extremely volatile. In other words, the value of these assets could and would change significantly and rapidly. Director knew the assets had to be sold as they were matched to the maturity of the deposits, and Director predicted (and gave reasons supporting his prediction) that whether interest rates went up or down, Franklin would incur losses when it sold these assets. Director's evidence also established that Franklin was the primary market for these high-risk assets. The district court's factual findings fail to address any of these concerns. The fact that Franklin was doing a good job monitoring these assets, was reducing the level of these assets, and had reduced the sensitivity

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[8] We note the above is a summary; however, the administrative record reflects it to be accurate. We also note the administrative record contains significant quantities of data supporting these conclusions.

to interest rate risk and prepayment risk, is simply irrelevant to Director's determinations. Quite simply stated: the district court ignored the data contained in the administrative record and Director's concerns; substituted its judgment for that of Director's concerning the acceptable level of these high-risk assets; ignored the predictive judgment of Director that a sale of these assets would likely result in a loss; and afforded no deference to Director's knowledge and expertise. Again, the district court, while using the language employed in the proper, arbitrary or capricious standard, in fact applied a de novo standard in its review.

There exists ample evidence in the agency record to establish a high level or undue concentration of high-risk assets. The most that can be said of Franklin's evidence concerning these high-risk assets and their level of concentration is that experts may disagree. Director's experts opined that forty per cent of such assets was too much, and Franklin's experts opined this level was acceptable. Conflicting expert opinion, however, is not sufficient to allow a reviewing court to conclude the agency decision was arbitrary, capricious or an abuse of discretion, nor is such evidence sufficient to overcome the presumption of regularity and correctness afforded to the appointment decision. *Overton*, 401 U.S. at 415; *Guaranty Sav.*, 794 F.2d at 1432.

We next turn our attention to Director's finding that Franklin placed undue reliance upon brokered deposits. The administrative record reveals that over seventy per cent of Franklin's deposits were brokered. Again we quote from the agency file:

> [T]he Association has funded its growth largely with brokered deposits. As of December 31, 1989, the Association had brokered deposits of $3,290,981,000, or 70.7% of total deposits . . . . [T]he high level of brokered deposits, an expensive source of funds, is

> contributing to the Association's narrow net interest margin and operating losses. . . . [T]he Association has no alternative, lower cost funding sources due to its limited amount of eligible collateral available to pledge against lower cost borrowings. The Association's excessive reliance on brokered deposits places it in an unsafe and unsound condition to transact business.

In looking to the district court's factual conclusions regarding Director's concerns over Franklin's high level of brokered deposits, *Franklin II* at ¶¶ 169-179, the court, based upon conflicting expert testimony, found the following: (1) Franklin's cost of brokered deposits was declining, *Franklin II* at ¶ 172; (2) Franklin was setting an interest rate significantly under the market and yet consistently obtained brokered deposits at that below market rate, *id.* at ¶ 173; (3) Franklin had a relatively low cost of these funds as Director failed to take into account the costs of servicing these accounts, *id.* at ¶ 174; (4) Franklin's cost of these funds included its hedging costs while other institutions did not, *id.* at ¶ 177; (5) Franklin's cost of funds plays no part in its investment decisions, *id.* at ¶ 178; and (6) therefore Franklin's cost of funds do not present a safety or soundness concern, *id.* at ¶ 179.

Again, the district court failed to appreciate the significance of Director's concerns. A financial institution obtains brokered deposits by soliciting these deposits. They are termed brokered funds because the financial institution pays a commission to the broker who obtains the funds. Indeed, the audit statement of Franklin's own accountants shows that Franklin paid such commissions in significant amounts—$1.9 million in the 1988-89 fiscal year, and $2.5 million in the 1989-90 fiscal year. These deposits are attracted by higher than normal interest rates from those persons wanting the best rate, but still wishing to maintain FDIC insurance. In reviewing

Franklin's own evidence, specifically the June 30, 1989 Form 10-K filed by Franklin, we find warnings to the investing public such as "[b]rokered deposits . . . constitute a significant percentage of the Association's unsecured liabilities," and brokered "[d]eposits . . . may be withdrawn from a thrift in the event of availability elsewhere of higher interest-earning investments for such funds." Franklin's Form 10-K explicitly warned investors that its operating strategy had resulted in significant "volatility in the earnings" and was expected to continue to do so in the future. Brokered deposits present two problems to a financial institution: first, they tend to increase the cost of funds; and second, they impair the institution's liquidity as most brokered deposits are short term. This means the institution must sell investments in order to obtain the money to pay off the maturing deposits. It is also important to note Congress has condemned reliance on brokered deposits, describing such reliance as "poor management." H.R. Rep. No. 101-54(I), at 299.

The district court ignored the question of whether Franklin unduly relied upon brokered funds. Instead, it focused on Franklin's cost of funds being low and therefore determined that Franklin's reliance upon brokered deposits for over seventy per cent of its total deposits was neither unsafe nor unsound. In so doing, the district court disregarded Director's concerns and his expert judgment. The district court in effect substituted for the judgment of Director, as to what constitutes undue reliance upon brokered deposits, the judgment of Franklin's experts, thus failing to give any deference to Director's knowledge, expertise and judgment. Even if the trial court was correct in its finding that "Franklin was able to set an interest rate significantly under the market and consistently obtain brokered deposits at that below market rate," *Franklin II* at ¶ 173, it did so by ignoring the agency file containing Director's specific comparisons.

Further, the district court completely ignored and failed to address the liquidity problems presented by Franklin's significant reliance upon these brokered deposits.

The fact that over seventy per cent of Franklin's deposits were brokered is clearly established in the agency record and is undisputed by Franklin. Director found this to be an unacceptable level or concentration of brokered deposits for a savings and loan association. Moreover, Congress has condemned such high reliance on brokered funds. Franklin presented experts who testified, in essence, that Franklin's reliance upon this level of brokered funds was acceptable. However, such contradictory expert testimony from a competing witness is not sufficient to allow a reviewing court to conclude the agency action was arbitrary, capricious, or an abuse of discretion, nor is it sufficient to overcome the presumption of correctness. *Overton*, 401 U.S. at 415; *Guaranty Sav.*, 704 F.2d at 1432.

When Director made the decision that reliance upon brokered funds for seventy per cent of total deposits was an unsafe or unsound condition, Director was making first, a policy decision, i.e., seventy per cent of total deposits being brokered is an unacceptable level, and second, a predictive judgment, i.e., Franklin had created an unacceptable level of risk for the depositors' funds. Substantial evidence existed to support this decision.

As discussed above, Director found Franklin was in an unsafe and unsound condition due to its significant level of high-risk assets and its undue reliance upon brokered deposits. Up to this point we have discussed Franklin's high concentrations of high-risk assets and brokered deposits, finding the administrative record clearly establishes both exist. We must still determine if the agency record justifies a finding these concentrations rendered Franklin's condition unsafe and unsound. What constitutes an unsafe and unsound condition is somewhat of an

amorphous concept, as it varies depending on the circumstances involved. It is clear, however, that an unsafe or unsound condition exists where a financial institution is operated in such a manner as to cause unacceptable levels of risk to its depositors' funds. Since a particular condition may not necessarily be unsafe or unsound in every circumstance, it must be judged in relation to all relevant facts. One of the clear purposes of FIRREA is to commit the progressive definition and eradication of such conditions to the director. *First Nat'l Bank of Lamarque v. Smith*, 610 F.2d 1258, 1265 (5th Cir. 1980). Whether a financial institution is in an unsafe or unsound condition is largely a predictive judgment (i.e., what may happen if this practice continues), and reviewing courts should be particularly deferential when they are reviewing an agency's predictive judgments, especially those within the agency's field of discretion and expertise. As we have pointed out, the role of a reviewing court is to determine whether the director's action was within his authority, was based upon a consideration of valid factors, and whether a clear error of judgment has occurred. *See* 5 U.S.C. § 706(2). In reviewing the director's decision to appoint a conservator, courts need not slavishly follow the director's decision. Rather, it is the function of the reviewing court to determine whether there is substantial evidence to support the statutory grounds of appointment. Here, such evidence clearly exists. Reliance by the district court upon one expert to the exclusion of another is insufficient to overcome the deference due Director's appointment decision. A contrary ruling would effectively strip Director of his regulatory and enforcement powers and place this authority in the hands of the savings and loan association.

B. *Depletion of Capital*

The second statutory ground for the appointment of a conservator Director found to exist was under 12 U.S.C. § 1464(d)(2)(A)(vii), which allows for the appointment

of a conservator if the director finds: "[T]he association has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and . . . there is no reasonable prospect for the replenishment of the capital . . . without Federal assistance . . . ."

The administrative record reveals an abundance of evidence supporting Director's decision concerning the likelihood of depletion of Franklin's capital. Franklin's net income margin had steadily and progressively declined from 2.34 per cent as of June 30, 1984 to .94 per cent on June 30, 1989. Franklin, by its figures, had a $9 million loss from June 30, 1988 to June 30, 1989. Franklin was paying dividends and large bonuses notwithstanding the loss. During 1988 and 1989, after being ordered to stop growing, Franklin nevertheless continued an aggressive growth rate in its assets (22.3 per cent) while its capital was decreasing. Franklin was also unsuccessful in obtaining outside capital. Nonetheless, for its fiscal year ending June 30, 1989, Franklin paid its eight executive officers $3.5 million in cash compensation and paid its owners dividends of $15 million. It "pumped up" its capital by $120.7 million with an unauthorized tax forgiveness agreement between it and its holding company. Franklin's core capital was only 2.1 per cent on November 30, 1989, after an adjustment for the tax forgiveness contract. Director deemed this a clear capital failure. While this finding was sufficiently dire itself, Director also noted his deep concern regarding Franklin's deferral of actual cash losses, which understated its current losses. By June 30, 1989: the deferred hedging losses were approximately $374 million, of which Director ordered $127 million be taken immediately; Director had significant evidence that the entire economic value of Franklin was only $70 million; Director was concerned that Franklin ran the risk of default on the bonds Franklin had issued having a face value of $2.9 billion, but which could cost Franklin $185 million to defease

the possible default; and Director felt Franklin should increase its valuation loss allowances to $49 million as a result of expected losses on its letters of credit. In sum, Franklin reported its capital to be $380 million, although Director felt there should be write-offs of $472 million. Under Director's most optimistic view Franklin had a net worth of only $70 million, falling well short of the capital requirements. Director believed there was no profit in Franklin's future; Franklin was only marginally profitable in one of the past five quarters; any gains on assets would be offset by future losses; Franklin was unable to restructure its portfolio to obtain profitability; and while the holding company had forgiven $110 million in deferred taxes, Franklin remained liable to the IRS and the holding company did not appear to have the resources to pay the taxes. Based on these and numerous other factors, Director concluded Franklin could not, in the foreseeable future, meet its capital requirements.

After hearing from both Franklin's and Director's expert accountants, the district court determined that although Franklin's methods of accounting for future losses was not widely used, *Franklin II* at 109, Franklin's deferral of its hedging losses was in accordance with GAAP, *id.* at ¶ 110, and had been approved by Franklin's outside auditors, *id.* at ¶ 111. The district court further determined Franklin's use of its "absolute value method" was a reliable method of testing correlation which was the keystone justifying Franklin's accounting deferral of its actual cash hedging losses, *id.* at ¶ 128; Franklin's computer modeling of future losses was an accurate basis upon which to defer these losses, *id.* at ¶ 189; and that it generally approved of the accounting methods of Franklin.

In making these findings, the trial court again rejected Director's expertise and experience and accepted the judgments and opinions of Franklin's experts in this eighteen-day de novo bench trial. The district court found that

even though Director's accounting standards were within GAAP, it would apply Franklin's accounting standards as Director's were too conservative.

Director had ordered Franklin to increase its loan loss valuation by $47 million to cover future losses expected to arise from Franklin's letters of credit. The trial court simply decided Director failed to properly evaluate this expected loss as Director did not give weight to the fact that Franklin would provide favorable financing to those who purchased the properties at the foreclosure sales. The trial court substituted this predictive judgment of Franklin's expert for that of Director. Even if we assume the district court was correct in decreasing the amount of this expected loss due to the possibility of favorable financing, the district court was not correct in deciding there would be no loss. At the very minimum there would be a decrease in earnings.

Director had ordered Franklin to increase its loan loss reserve by $185 million to account for predicted expenses necessary to defease a possible default in Franklin's bonds. The district court found default had not occurred and "was not an event likely to occur." *Franklin II* at ¶ 157. Again, this finding was based on the court's substituting the predictive judgments of Franklin's experts for those of Director.

Following Franklin's unauthorized entry into a tax forgiveness agreement with its holding company—a device Franklin had used to increase its capital—Director ordered Franklin to write down its capital $110 million. Director reasoned that Franklin was still responsible to the IRS for the taxes and, in any event, the holding company lacked the ability to pay. Notwithstanding Director's reasoned analysis, the trial court found no taxes were due at the time the conservator was appointed, and the holding company *did* have the ability to pay any tax that might come due in that it could borrow the money, sell stock,

or liquidate Franklin. Franklin II at ¶ 165. These findings were again in disregard of Director's judgment and analysis. We feel compelled to observe that Franklin's holding company had virtually no assets except Franklin's stock and a small cash account.

When reviewing an agency's decision concerning matters lying within the agency's field of expertise, a reviewing court should begin by acknowledging that a presumption of procedural and substantive regularity attaches. *Overton*, 401 U.S. at 415; *Guaranty Sav.*, 794 F.2d at 1432. The reviewing court, particularly when reviewing such technical determinations and predictive judgments, must apply a deferential standard of review. Reliance on testimony of one competing expert to the exclusion of another is insufficient to overcome the presumption of correctness that the agency enjoys in its particular area. This presumption is even stronger where Congress has charged an agency with complex analytical responsibilities and the duty to make predictive judgments.

This does not mean all agency decisions are unimpeachable. A reviewing court should not blindly follow an agency decision. In the instant case, it is the responsibility of the reviewing court to determine if there is substantial evidence in the director's administrative file to support a finding of the existence of one of the statutory grounds for appointment of a conservator. A director's decision to appoint a conservator when based upon technical matters such as: unacceptable levels of high-risk assets and acceptable levels of liabilities; accounting standards; the level of loan loss reserves; and predictions of future losses, should not be set aside by the reviewing court unless the findings transgress the bounds of reason.

In reviewing Director's decision to appoint a conservator, we need only inquire whether this decision had a rational basis as shown by the administrative record. The focus of this inquiry is whether a statutory ground for

the appointment of a conservator existed at the time the decision was made. The inquiry should not focus on credibility determinations as to which experts are more persuasive or which have the better analytical and predictive abilities. We find Director's second statutory ground upon which he based his decision is fully supported in the administrative record and provided a valid basis for the appointment decision.

C. *Substantial Dissipation of Assets or Earnings*

The third statutory ground for the appointment of a conservator that Director found to exist is contained in 12 U.S.C. § 1464(d)(2)(A)(viii), which allows for the appointment of a conservator or receiver if "there is a violation or violations of laws or regulations, or an unsafe or unsound condition which is likely to cause either insolvency or substantial dissipation of assets or earnings, or is likely to weaken the condition of the association or otherwise seriously prejudice the interests of its depositors."

Much of Director's evidence concerning capital depletion is also applicable to this statutory ground and need not be repeated. It is nevertheless appropriate to discuss briefly some of the remaining factors underpinning Director's finding.

The proper amount of capital is essential to the continued operation of any financial institution. Director's evidence established the probability of future capital inadequacy, yet the district court found that Franklin had the means to comply with all capital requirements.

We first examine Director's evidence. Franklin's net interest margin had been steadily shrinking, and in fact was negative in three of its last four quarters. In its fiscal year 1988-89, Franklin reported a net loss of $9 million. Franklin's operating trends revealed Franklin

was likely to experience additional losses in the foreseeable future. In short, Franklin was unable to generate capital through earnings. Moreover, it was highly unlikely that Franklin could raise outside capital. *Franklin II* at ¶ 52. Presumably its ownership was unable or unwilling to inject any additional capital of its own. Director opined that in light of Franklin's poor operating results and negative trends its recent aggressive and significant growth was not prudent and the institution was unable to provide the necessary capital to support such growth.

In order that Director could be assured of capital adequacy, Director ordered certain adjustments to capital. These adjustments included: (1) a $119 million write-down in order that the capital would accurately reflect hedging losses that Franklin had deferred (this also had the effect of understating current losses); (2) a $47 million write-down to accurately reflect a valuation allowance in loss reserves, and to accurately reflect the amount of losses Director predicted Franklin would incur as a result of letters of credit Franklin had issued guaranteeing payment of various industrial revenue bond issues; (3) a write-down of $185 million to provide an allowance to assure Franklin's $2.9 billion zero coupon bonds; (4) a write-down of $110 million to accurately reflect an unauthorized tax forgiveness agreement between Franklin and its holding company, which resulted in an increase in Franklin's stated capital; and (5) as Franklin had included in its capital investment Sun Life Insurance Company's purchase of a block of insurance policies, Director ordered a write-down of $33 million, which was included in Franklin's capital as a part of its supervisory goodwill.

A summary of Director's concerns about Franklin's lack of capital is simple. On June 30, 1989, Franklin reported its total capital requirements as being $274 million. Franklin's own Form 10-K report explicitly states:

> Unless the Association significantly increases its capital, reduces its investments in an extension to such subsidiaries, or restricts the impermissible activities of such subsidiaries, on a fully phased-in basis this new requirement for calculating capital could have a material adverse effect on the Association's capital.

This Form 10-K also contains many warnings to potential investors that Franklin's capital structure may become inadequate.

Again we look at the district court's treatment of Director's concerns about Franklin's capital structure. The court found, based upon Exhibit 603, that Franklin had the ability to comply with all regulatory capital requirements through transactions already scheduled to occur. *Franklin II* at ¶ 84. The district court then determined the investment in Franklin's Saver's Life subsidiary was properly included in its capital. *Id.* at ¶ 86. It further found no write-down was necessary to properly reflect current losses on Franklin's hedging as Franklin used the better accounting standards. It determined Director had wrongfully valued the expected losses from Franklin's letters of credit in that Director failed to take into account the value of Franklin's financing of the anticipated buyers of these foreclosed properties. *Id.* at ¶ 154. The court determined Director's prediction of the moneys needed to avoid default upon the bond issue was incorrect, *id.* at ¶¶ 155-158, and that it was acceptable for Franklin to apply the tax forgiveness to its capital, *id.* at ¶¶ 159-168.

To reach these results the district court had to ignore the evidence contained in the administrative record and accept without question Franklin's competing evidence. The district court furthermore had to ignore or disregard Director's predictive judgments and completely accept all the testimony given by Franklin's experts. Finally, the district court had to reject Director's accounting standards and adopt Franklin's. While both competing account-

ing standards were in accordance with GAAP, the district court failed to give the appropriate deference to the standards specified by Director, stating only that Director's standards were "extremely conservative." *Id.* at ¶ 101. Basically, the district court found Director's decisions arbitrary based upon competing expert testimony and gave no deference whatsoever to Director's expertise and predictive judgments.

The proper inquiry under the arbitrary and capricious standard is not which expert is more impressive, or even if the reviewing court *agrees* with a particular view over another. Rather, the appropriate inquiry of the reviewing court is whether a reasonable person considering the matters on the agency's table could find a rational basis to arrive at the same judgment as made by the director.

Reviewing the evidence contained in the administrative file and giving Director's predictive judgments due deference, we find: the decision to appoint a conservator supported by substantial evidence; the evidence clearly establishes the existence of the statutory grounds for the appointment of a conservator; and Director's conclusions were reasonable.

IV.

Franklin's Cross-Appeal

Franklin appeals the portion of the district court's judgment that holds Mr. Wall had authority as a de facto officer to appoint a conservator for Franklin.

The district court held Mr. Wall was unconstitutionally appointed to serve as director of the Office of Thrift Supervision. *See Franklin Sav. Ass'n v. Director of Office of Thrift Supervision*, 740 F. Supp. 1535, 1541 (D. Kan. 1990). We need not decide the correctness of this determination as it has not been appealed.

The district court, applying the doctrine of de facto officer, ruled that when governmental action is challenged

on the ground the official taking the action was improperly in office, the challenged acts will be upheld in the interests of the public. *Id.* Franklin concedes the existence of this legal principle yet urges us to refuse to adopt and apply the de facto officer doctrine as doing so would subvert adherence to the Appointments Clause, citing *Andrade v. Lauer*, 729 F.2d 1475 (D.C. Cir. 1984), in support of its position.

We previously have been invited to reject the de facto officer doctrine and declined. *Horwitz v. State Board of Medical Examiners*, 822 F.2d 1508, 1516 (10th Cir.), *cert. denied*, 484 U.S. 964 (1987). In *Andrade*, the court held that a specific, focused attack on a particular agency action (i.e., termination of plaintiffs' employment with the agency) would be permitted when the agency had actual notice of the claimed appointment defect and suit was filed promptly. 729 F.2d at 1500. The *Andrade* court made clear its holding would not be mechanically applied but it would require courts to pay "due attention to equitable factors." *Id.* We are not persuaded *Andrade* requires a result contrary to that reached. Moreover, we find *Horwitz* precludes its application to the facts of this case.

The district court found that notwithstanding Mr. Wall's defective appointment, it would exercise its remedial discretion to uphold Mr. Wall's appointment of a conservator to Franklin. *Franklin*, 740 F. Supp. at 1542; *see also Buckley v. Valeo*, 424 U.S. 1 (1976) (refusing to invalidate past acts of the Federal Election Commission despite the Court's finding that the commission's appointments violated the Appointments Clause). Franklin contends this was not an appropriate case for the court to exercise its remedial discretion and power. We disagree. Equitable remedies are within the sound discretion of the trial court. *Buckley*, 424 U.S. at 142; *Andrade*, 729 F.2d at 1499 n.39. Franklin has failed to persuade us the trial court abused its discretion by its ruling.

Conclusion

A review of the administrative file clearly reveals a high-flying,[9] debt-laden, troubled savings and loan. The record reveals the owners diverting millions of dollars into their pockets through large salaries, bonuses and dividends, notwithstanding the losses being incurred by the association. The record reveals a financial institution taking what the director deemed to be unacceptable risks with its depositors' monies. In fact, the record reveals a financial institution both unable and unwilling to comply with the director's requirements relating to safety and soundness concerns.

The ultimate question underlying this dispute is: Who is vested with the responsibility for determining the quality of assets, the proper levels and types of assets and liabilities, appropriate accounting standards, and the numerous other questions relating to the safe and sound condition of a financial institution? Congress has answered this question by enacting FIRREA, which clearly vests this responsibility in the director.

The district court first improperly expanded its scope of review as it allowed testimony by Franklin's experts giving opinions on such matters as acceptable levels of brokered deposits and high-risk assets. Secondly, the district court erred by improperly applying the standard of review when it accepted such expert opinion. By so doing, the district court effectively usurped Director's regulatory and enforcement powers and placed these powers into the hands of Franklin. Congress has given the director, not the courts, the power to define what is an unsafe and unsound condition.

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[9] Franklin has numerous subsidiaries which in turn had subsidiaries which in turn had at least one subsidiary. Some were engaged in the insurance business and some were broker-dealers. One, L.F. Rothschild & Co., Inc., filed for Chapter 11 protection after incurring a $1.2 billion loss in its 1987-88 fiscal year. It attempted to purchase a Beverly Hills savings and loan and was stopped by Director.

We have reviewed the agency record utilizing the arbitrary and capricious standard of review. Our review persuades us Director's decision was not arbitrary, capricious or an abuse of discretion. The decision was supported by substantial evidence and is in accordance with the applicable law.

Accordingly, the decision of the district court is REVERSED and VACATED. This matter is REMANDED to the district court with instructions to dismiss the action.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 90-3272
90-3281

FRANKLIN SAVINGS ASSOCIATION, a Kansas Savings and Loan Association and FRANKLIN SAVINGS CORPORATION, a Kansas corporation, on behalf of itself and in its derivative capacity as controlling shareholder of Franklin Savings Association,

Plaintiffs-Appellees/
Cross-Appellants,

v.

OFFICE OF THRIFT SUPERVISION,
Director Department of the Treasury,
Defendant-Appellant/
Cross-Appellee,

and

UNITED STATES OF AMERICA,
Defendant-Intervenor/
Cross-Appellee.

ORDER

Filed September 10, 1991

Before HOLLOWAY, Chief Judge, SETH, McKAY, MOORE, ANDERSON, TACHA, BALDOCK, BRORBY and EBEL, Circuit Judges.

This matter comes on for consideration of appellees' petition for rehearing and suggestion for rehearing en banc in the captioned cause.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision sought to be reheard.

In accordance with Rule 35(b) of the Federal Rules of Appellate Procedure, the petition for rehearing and suggestion for rehearing en banc were transmitted to all the judges of the court in regular active service. No member of the hearing panel and no judge in regular service on the court having requested that the court be polled on rehearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

Entered for the Court

/s/ Robert L. Hoecker
ROBERT L. HOECKER
Clerk

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF KANSAS

Civil Action Case No. 90-4054-S

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Plaintiffs,

v.

DIRECTOR OF THE OFFICE OF THRIFT SUPERVISION,
Defendant.

MEMORANDUM AND ORDER

[Filed Sep. 5, 1990]

In this case, Franklin Savings Association ("Franklin" or "the institution") and Franklin Savings Corporation ("FSC") challenge the Office of Thrift Supervision's ("OTS" or "the regulator") February 15, 1990, decision to appoint the Resolution Trust Corporation ("RTC") as conservator for the institution. Franklin attacks the legality of the appointment and seeks removal of the conservator, pursuant to Section 5(d)(2)(E) of the Home Owners Loan Act ("HOLA"), as amended by Section 301 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), 103 Stat. 292 (to be codified at 12 U.S.C. § 1464(d)(2)(E)).

This case was filed on March 12, 1990, and was placed on an accelerated docket, given the crucial importance of timely action regarding this matter. An 18-day trial to the court was conducted between June 25, 1990, and July

20, 1990. In addition to considering the testimony and evidence presented at trial, the court has read numerous depositions submitted by the parties and has thoroughly examined the three volume administrative record compiled by OTS regarding the appointment of conservator. The court is now prepared to rule.

As an initial matter, the court wishes to comment that this is not a case involving an infamous or notorious savings and loan association, the likes of which the public has recently become more than familiar. This is not a case involving fraud, corruption, or self-dealing by the management or directors of Franklin.[1] There has been no allegation or even hint of illegal or unethical conduct by Franklin's management or directors. Essentially, this case boils down to a dispute over accounting practices. With that said, the following constitutes the court's findings of fact and conclusions of law pursuant to Rule 52(a) of the Federal Rules of Civil Procedure.

I. THE PROPER ROLE OF THE COURT

Before discussing the specific findings and conclusions in this case, it is necessary for the court to address exactly what role it is to play when a savings association challenges the regulator's appointment of a conservator. Legal questions must be resolved regarding the standard of review to be applied in reviewing the regulator's actions; the burden of proof; and what evidence the court can consider in resolving this case. In FIRREA Congress

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[1] The court has reviewed defendant's recent submission of additional authority, *Lincoln Savings & Loan Assoc. v. Wall*, Nos. 89-1318 and 89-1323 (August 22, 1990, D.D.C.). The court finds this authority of little value or guidance to the present case. The facts established in *Lincoln* show clear justification for the regulator's actions. Here, unlike in *Lincoln*, the directors and management of Franklin have not abused their position and have not been looting the institution. Each case must be resolved on its own factual situation.

specifically provided for judicial review of the regulator's appointment of conservator.[2]

A. *Standard of Review*

The provision of FIRREA which allows judicial review of the OTS's decision to appoint a conservator does not expressly define the scope or standard of that review.[3] Since the statute does not specifically define the standard of review to be used in examining regulator's action, the court must look to the Administrative Procedures Act for guidance on this issue. *See Washington Federal Savings & Loan Ass'n v. FHLBB*, 526 F. Supp. 343, 350, 353-54 (N. D. Ohio 1981). Section 706 of the Administrative Procedures Act ("APA") sets forth the standard of review appropriate for a court reviewing an administrative

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[2] FIRREA specifically states:

> The Director shall have exclusive power and jurisdiction to appoint a conservator or receiver for a Federal savings association. If, in the opinion of the Director, a ground for the appointment of conservator or receiver for a savings association exists, the Director is authorized to appoint ex parte and without notice a conservator or receiver for the savings association. In the event of such appointment, the association may within 30 days thereafter, bring an action in the United States district court for the judicial district in which the home office of such association is located . . . for an order requiring the Director to remove such conservator or receiver, and the court shall upon the merits dismiss such action or direct the Director to remove such conservator or receiver.

FIRREA, Pub. L. No. 101-73, 103 Stat. 292, amending § 5(d)(2)(E) of HOLA (to be codified at 12 U.S.C. § 1464(d)(2)(E)). The statute provides this court with jurisdiction over this matter and venue since Franklin's home office is in Ottawa, Kansas, within this judicial district.

[3] The court is aware that the statute provides that the court shall "upon the merits" grant appropriate relief. This court finds that the "upon the merits" language does not specifically concern the standard of review in this action, but instead concerns the scope of evidence that the court may consider in reaching a decision. *See, infra.*, at pp. 7-10.

agency's action.[4] The APA provides that an agency action must be set aside if the action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or if the action failed to meet constitutional, statutory, or procedural requirements. 5 U.S.C. § 706(2)(A), (B), (C), (D). Although the APA allows for *de novo* review in limited situations, 5 U.S.C. § (2)(F), the court finds it is not applicable to the present case and that the standards set out in 5 U.S.C. § 706(2)(A), (B), (C) and (D) apply in the present proceeding. Under the arbitrary, capricious and abuse of discretion standard, the agency's decision is entitled to a presumption of regularity. The presumption, however, does not shield the agency's action from "a thorough, probing, in depth review." *Citizens to*

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[4] Section 706 states:

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be—

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

Preserve Overton Park v. Volpe, 401 U.S. 402, 415 (1971). The court must consider whether the OTS's decision to appoint a conservator was based on the consideration of the relevant factors and whether there has been a clear error of judgment. *Id.* at 416. "Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency." *Id.* Notwithstanding this deference, the agency must "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n v State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting, *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

B. *Burden of Proof*

The general rule is that the party challenging an agency's action has the burden of proving error. *Telegraph Savings & Loan Ass'n. v. FSLIC*, 564 F. Supp. 862, 870 (N.D. Ill. 1981) (citing *Pacific States Co. v. White*, 296 U.S. 176 (1935)). A presumption of validity exists for the agency's action. When an agency acts ex parte, as in the present case, its decision is still entitled to presumption of correctness, albeit a lesser one. *Telegraph Savings & Loan*, 564 F. Supp. at 870. Thus, the burden is on Franklin to overcome this presumption and to show by the preponderance of the evidence that the agency's decision lacked any basis in fact or law or was arbitrary, capricious, or an abuse of discretion.

C. *Evidence the Court Can Properly Consider*

Throughout this case, the parties have disputed what evidence the court may properly consider in making its judicial review of the OTS's action. The OTS contends that the court is limited to reviewing solely the adminis-

trative record which OTS has prepared and filed with the court. The OTS argues that the court must determine if the agency's action is supported by the administrative record. Franklin insists that the court consider evidence outside the administrative record to determine the appropriateness of the conservatorship. The court has received an extensive amount of evidence outside the administrative record during the trial of this case, but took under advisement the issue of whether such evidence could be considered in determining the issues before the court.

After considering the parties' arguments and reviewing much case law, and some of the facts established in this case, this court finds, and is convinced, that evidence outside the administrative record may be properly considered. First, the court notes that the statutory scheme for judicial review set out in FIRREA calls for review "upon the merits." Courts interpreting this "unusual" phrase have reached a variety of conclusions on its meaning and what type of review is required by the phrase "upon the merits." Some courts find that the phrase should be given no different effect than the phrase "on the record," and thus, apply the traditional arbitrary and capricious standard of review, in which the court simply reviews the administrative record and determines whether, based on *that* record, the agency's action was arbitrary and capricious or an abuse of discretion. *See Woods v. Federal Home Loan Bank Board*, 826 F.2d 1400, 1406-07 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Guaranty Savings & Loan Ass'n. v. Federal Home Loan Bank Board*, 794 F.2d 1339, 1342 (8th Cir. 1986). Other courts have held that this language in effect provides a *de novo* review of the agency's decision. *See Fidelity Savings & Loan Ass'n. v. FHLBB*, 540 F. Supp. 1374, 1377 (N.D. Cal. 1982) ("If it means nothing more, the term 'on the merits' reveals that a proceeding under the statute is more in the nature of a *de novo* review than an appellate review."); *Telegraph Savings & Loan Ass'n. v. FSLIC*, 564 F. Supp. 862, 869-870 (N.D. Ill. 1981);

A third view is advocated in *Collie v. Federal Home Loan Bank Board*, 642 F. Supp. 1147, 1150-52 (N.D. Ill. 1986). The *Collie* court determined that the "upon the merits" language provides for a hybrid type of review in which the court would continue to apply the arbitrary and capricious standard of review, but that the record on which the review would be based is expanded. The challenging party is provided an opportunity to present evidence in addition to the administrative record. As the *Collie's* court properly surmised:

> A reasonable reading of the phrase "upon the merits" is rather that it means a review in which the FHLBB [predecessor of OTS] does not necessarily control the evidence which reaches the reviewing court. "Upon the merits" contrasts with the more usual "on the record." Congress must not have intended for judicial review always to be confined to an administrative record . . . . [T]he challenging association should have the opportunity to submit evidence whether or not that evidence was considered by the Board, and to develop any facts bearing on the question of whether any of the statutory grounds existed. "Upon the merits" means that both parties to the reviewing action have the right to develop the judicial record.
>
> Nevertheless, it does not follow from that conclusion that review "upon the merits" is the equivalent of either a *de novo* hearing or *de novo* review of the evidence . . . . The FHLBB's opinion that insolvency, violations or unsound practices existed therefore must carry some weight.

Collie, 642 F. Supp. at 1151 (citations omitted). The essence of the "upon the merits" language is that the savings association is provided with a meaningful opportunity to present its case in opposition to the appointment of the conservator at some point during the process leading to the appointment. If such meaningful opportunity

has not been provided, "then the court should provide that opportunity." *Id.* at 1152.

This court agrees with the *Collie* court's interpretation of the phrase "upon the merits." To allow the government to seize control of plaintiff's business and assets in an ex parte nature without a previous adversarial hearing would deny plaintiffs any meaningful opportunity to present their position. The court finds that to allow this sort of seizure of property without at least allowing plaintiffs a post-seizure opportunity to present evidence supporting their case in opposition of the conservatorship, would definitely raise serious constitutional due process concerns. *See, infra.*, Conclusion of Law No. 15. The court chooses to interpret this statutory language in a manner that will allow it to withstand a constitutional challenge. The statutory scheme grants OTS the exclusive power to place the institution in conservatorship ex parte and without notice. Section 5(d)(2)(E) of HOLA as amended by Section 301 of FIRREA, Pub. L. No. 101-73 (to be codified at 12 U.S.C. 1464 (d)(2)(E)). This scheme is acceptable in light of the necessity that the regulator must act quickly and decisively in reorganizing, operating and dissolving failed institutions. *See Woods* at 1407. However, such an ex parte regulatory scheme may be allowed only if the seized institution is provided with an opportunity to later present its position. This court reads the judicial review provision in FIRREA as providing such an opportunity by judicial review on the merits after the agency's action.

To provide a meaningful review, the court must consider evidence outside the administrative record. Therefore, the court concludes that the "on the merits" review provides the plaintiffs with an opportunity to present evidence outside the administrative record in support of their case and for the court to consider such evidence. However, this hybrid standard of review does not provide for *de novo* review, but for review on whether the agency's

action was based on statutory grounds or was arbitrary and capricious or an abuse of discretion after the court has reviewed all evidence presented.

Aside from the "on the merits" statutory language, the court also finds that evidence outside the administrative record may be considered under other general principles of administrative law. Generally, judicial review of an agency action is limited to review of the record on which the administrative decision was based. *Thompson v. U.S. Dept. of Labor*, 885 F.2d 551, 555 (9th Cir. 1989) (citing *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. at 420). Judicial review should be based on the full administrative record in existence at the time of the agency decision. *Public Power Council v. Johnson*, 674 F.2d 791, 794 (9th Cir. 1982) (citing *Camp v. Pitts*, 411 U.S. 138, 142 (1973)). The Ninth Circuit Court of Appeals has expounded on what constitutes the "whole administrative record" by stating:

> The whole administrative record, however, "is not necessarily those documents that the *agency* has compiled and submitted as 'the' administrative record." "The 'whole' administrative record, therefore, consists of all documents and materials directly or indirectly considered by the agency decision-makers and includes evidence contrary to the agency's position.

Thompson v. U.S. Dept. of Labor, 885 F.2d at 555 (emphasis in the original) (citations omitted.) Also, the court may consider evidence outside the designated administrative record to determine the adequacy of the designated record. *Animal Defense Council v. Hodel*, 840 F.2d 1432, 1436 (9th Cir. 1988).

After considering the evidence presented at trial, the court is convinced that the three volume administrative record as designated by the OTS is not the "whole administrative record" relied on by the agency in reaching its decision to appoint a conservator. The court finds

that many documents and matters considered and reviewed by OTS personnel in reaching the decision to appoint a conservator were excluded from the administrative record.[5] The court finds that evidence of additional material considered by the OTS which was not made part of the designated administrative record was properly presented to the court for its consideration in reaching the decision made today. The administrative record presented to the court was a selective compilation of documents considered by OTS and not the "whole administrative record" reviewed and considered by OTS personnel in reaching its decision to appoint a conservator.

Moreover, the court finds that the extensive amount of testimony presented at the trial explaining finance accounting principles and various types of securities can be properly considered by the court in reaching its decision regarding the appropriateness of the conservatorship. Supplementation of the administrative record is appropriate if necessary to explain technical terms or complex

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[5] The documents missing are numerous. Examples of documents not included as part of the administrative record include correspondence from Franklin responding to matters raised by OTS: Exhibits 314 and 598 (the December 19, 1989, letter responding to OTS's November 3, 1989, concern); Exhibit 316 (Franklin's February 8, 1990, response regarding OTS's concerns on TB 12 assets.); Exhibit 299 (January 5, 1990 letter to Bruce Benson from Franklin and Deloitte & Touche); Exhibit 9 (Kurt Schoeb's January 5, 1990, letters to Benson). Many meetings between OTS personnel and Franklin's management or with its independent accountant are mentioned in some documents in the administrative record. However, there is no notation of what issues were discussed or what Franklin's positions were regarding those issues or what statements were made at these meetings. Exhibit 2596 (Benson's January 25, 1990, letter to Franklin regarding Deloitte & Touche's January 5, 1990, letter) is not in the administrative record. Conferences among OTS staff and the OTS decision-makers in Topeka and Washington, D.C., were apparently held regarding the Franklin situation. The contents of these conversations were not made part of the administrative record. *See Biscayne Fed. Savings & Loan v. Federal Home Loan Bank Board*, 572 F. Supp. 997, 1006 (S.D. Fla. 1983).

subject matter involved in an agency's action. *Animal Defense Council v. Hodel*, 867 F.2d 1244 (9th Cir. 1989) (amending 840 F.2d 1432, 1436 (9th Cir. 1988)).

The OTS's decision to appoint a conservator was based on its decisions regarding the accounting principles and practices employed by Franklin and Franklin's involvement in certain security transactions. To adequately review the OTS's actions, the court, by necessity, had to acquire a basic understanding of finance accounting principles and the types of securities in which Franklin was involved. Therefore, the court has properly considered general evidence on these matters. Also, to conduct a legitimate review of the agency's action, the court had to acquire an understanding of the accounting methods used by Franklin and those advocated by the regulator. Thus, the court finds that due to the complex subject matter involved in this case and the technical terms involved, evidence outside the administrative record is appropriate for the court's consideration.

Finally, in addition to the reasons set forth above, the court finds that additional evidence outside the administrative record is admissible and may be considered due to the fact that this case concerns disputes over the interpretation of regulations. *See Apex Constr. Co. v. United States*, 719 F. Supp., 1144, 1147, n. 1 (D. Mass. 1989); *Exxon Corp. v. Dept. of Energy*, 91 F.R.D. 26, 40-42 (N.D. Tex. 1981).

For all the foregoing reasons, the court finds that it is not limited, in its review, to the three volume administrative record as designated by OTS. The court has, and properly so, accepted and considered evidence outside of the three volume administrative record.

II. FINDINGS OF FACT.

A. *General Background.*

1. Plaintiff Franklin Savings Association is a federally insured, stock savings and loan association chartered by the state of Kansas in 1889 with its principal place of business in Ottawa, Kansas. Plaintiff Franklin Savings Corp. is a Kansas corporation that holds approximately 94 percent of the issued and outstanding guarantee stock of Franklin. The Ernest Fleisher family is the beneficial owner of 55 percent of FSC. The Ted Greene family is the beneficial owner of the remaining 45 percent. FSC has no material assets other than its Franklin stock. The approximately remaining 6 percent of Franklin's stock, which is not owned by FSC, is owned by Franklin's employees under an employee stock ownership plan or is publicly traded on the National Association of Securities Dealers Automated Quotation ("NASDAQ").

2. Franklin's primary business is earning income based on the net spread between the interest income on mortgage related assets and the cost inherent in acquiring and carrying those assets. Mortgage related assets generally consist of loans secured by an interest in real estate and the cash flows from such loans evidenced by pass through certificates, which represent ownership interests in a pool of mortgaged loans, guaranteed by the United States government or its instrumentalities; mortgaged derivative products secured by such pass through certificates; and private mortgage participation certificates which have received one of the two highest ratings of the rating categories of a nationally recognized rating organization.

3. Defendant Office of Thrift Supervision is an agency of the United States of America. OTS was created in 1989 with the enactment of FIRREA. The director of OTS has all the powers that had been vested in the Federal Home Bank Board prior to the enactment of FIRREA, except for those powers which were transferred

to other agencies. Among the powers vested in the director of OTS is the power to appoint a conservator or receiver for a savings association. 12 U.S.C. § 1464(d)(2)(E).

4. David A. Douglass is the commissioner of the Kansas Savings and Loan Department, a state agency responsible for regulating and monitoring the activities of state chartered savings and loan associations.

5. On February 15, 1990, M. Danny Wall, then director of OTS,[6] appointed the Resolution Trust Corporation as conservator of Franklin based on his findings that:

A. Franklin was in an unsafe and unsound condition to transact business, including having substantially insufficient capital or otherwise;

B. Franklin had incurred or was likely to incur losses that would deplete all or substantially all of its capital, and that there was no reasonable prospect for Franklin's capital to be replenished without federally funded assistance;

C. There was a violation or violations of laws or regulations, or unsafe or unsound practice or condition which was likely to cause insolvency or substantial dissipation of both assets or earnings, or was likely to weaken the condition of the association or otherwise seriously prejudice the interest of its depositors.

6. On February 15, 1990, Commissioner Douglas gave written approval that one or more of the statutory grounds specified for the appointment of a conservator for Franklin existed.

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[6] In our earlier Memorandum and Order of June 22, 1990, this court has found that Director Wall was unconstitutionally appointed to serve as a government officer. However, under the doctrine of *de facto* officer, the court ruled that the actions of Mr. Wall may withstand a challenge based on his unconstitutional appointment.

7. On March 12, 1990, FSC and Franklin filed this lawsuit[7] contesting OTS's appointment of the RTC as conservator and seeking interim injunctive relief preventing OTS from appointing a receiver.[8]

8. Ernest M. Fleischer served as chairman of the board of Franklin Savings Association until the appointment of conservator on February 16, 1990. Mr. Fleischer has a bachelor of arts degree, a bachelor of science degree in business administration and a masters degree in business administration from Washington University in St. Louis, Missouri. He also has a law degree from Harvard Law School. In 1957 Mr. Fleischer passed the certified public accountant (CPA) examination.

9. Mr. Fleischer practiced tax law from 1959 to 1985 and has been involved in the regulation and operation of

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[7] Defendant has moved to dismiss this action on the grounds that it was initiated by Mr. Fleischer on behalf of the institution and that he lacked authority to initiate such suit on behalf of the institution. The court finds as fact that the board of directors delegated to Mr. Fleischer, as chairman of the board, the authority to initiate a lawsuit on behalf of the institution if it was necessary. The board made a determination to challenge the OTS's ordered adjustments "by all appropriate means." This determination would include the initiation of the present lawsuit. This is not a case of a shareholder bringing a derivative suit, and thus, defendant's reliance on *Gaubert v. FHLBB*, 863 F.2d 59 (D.C. Cir. 1988) is not persuasive. The court finds that without doubt the institution authorized and wanted this lawsuit prosecuted and that Mr. Fleischer was authorized to initiate this suit in the name of the institution. Finally, it is generally recognized that if a corporation does not object to an officer's lack of authority, a third person may not so object. *See Farmer's Union Oil Co. v. Maixner*, 376 N.W. 2d 43, 46 (N.D. 1985); *Int'l Tours and Travel v. Khalil*, 491 A.2d 1149, 1153 n. 9 (D.C. App. 1985); *Village of Brown Deer v. City of Milwaukee*, 16 Wis. 2d 206, 114 N.W.2d 493, 497, *cert. denied* 371 U.S. 902 (1962).

[8] Pursuant to an agreed order entered by this court on March 30, 1990, plaintiffs were granted a preliminary injunction preventing the OTS from converting the conservatorship into a receivership without 24 hours notice to the court and to Franklin.

the thrift industry since the 1960s in connection with his law practice.

10. In 1967 Mr. Fleischer acquired 25 percent interest in General Savings Association. Mr. Fleischer, Carson Cowherd and Ted Greene were the owners of General Savings Association. Following an exchange of stock between Messrs. Cowherd and Fleischer, Mr. Fleischer relinquished his interest in General Savings Association and acquired an interest in Franklin Savings Association.

11. In 1974 Franklin reported an accounting loss. Therafter, Harry Coffman, a member of Franklin's board of directors, commented on the inherently risky nature of the business of operating a savings and loan association. Coffman noted that the risk in the thrift industry resulted from the fact that thrift institutions had to solicit from the public short term deposits to invest in long term fixed rate assets. If interest rates increased, the savings and loan would have to pay increasing rate on deposits even though it had been previously locked into a fixed rate of return on its assets portfolio of long term home loans. If interest rates increased, the association would also face a potential credit crunch because depositors would withdraw their money from the savings and loan institution, whose maximum interest rate at that time was set by regulation, and invest it in institutions offering higher rates of return.

12. Another risk to which Franklin and other thrifts are exposed is prepayment risk. Prepayment risk results from the option included in home mortgages which allows the home mortgagor to prepay the mortgage obligation. The mortgagor will more likely exercise this option if the prevailing interest rate drops below the rate of the mortgage note.

13. In the late 1970s and early 1980s, interest rates rose dramatically from about 8 percent to about 18 percent, a change of 1000 basis points. A basis point is

1/100 of 1 percent change in interest rate. A change in 100 basis points equals a change of 1 percent in the interest rate. This period of dramatic escalation of interest rates caused the true thrift crisis in the United States.

14. At the time of these rapidly rising interest rates, the balance sheet of Franklin appeared favorable based on GAAP figures, under which its assets were carried at a historical cost, rather than current market value. Franklin knew, however, that if interest rates remained high, capital would soon become depleted because depositors would invest their funds at new higher rates as their deposits matured with Franklin.

15. During the late 1970s and early 1980s, Congress responded to the crisis in the thrift industry by deregulating that industry and allowing thrifts to enter broader categories of business and to no longer cap the rate at which the institutions could pay interest on deposits. *See generally* The Depository Institutions Deregulation Act of 1980, Pub. L. No. 96-221, 94 Stat. 142 (1980); and The Garn-St. Germaine Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982).

16. During this period, Franklin discovered that it had economic losses in place that ranged from $40-60 million. To address these losses, Franklin retained Dr. Wayne Angeli, then a professor of economics and finance at Ottawa University in Ottawa, Kansas.[9] Dr. Angell was retained to determine whether Franklin could earn back the losses already in place and continue to operate as a profitable business.

17. In 1981 Dr. Angell determined that Franklin could earn a safe deposit on the purchase of Government National Mortgage Association ("GNMA") mortgage backed securities ("MBS"). Dr. Angell's analysis indicated that these securities could be purchased at a value that far exceeded the cost of funds to carry those assets.

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[9] Dr. Angell currently is a member of the Board of Governors of the Federal Reserve System.

18. In 1982 Franklin began buying deep discount Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corp. ("Freddie Mac") mortgage backed securities. These securities, unlike the GNMA assets, were not backed by the full faith and credit of the United States government, but carried federal agency status. Franklin decided to acquire these securities because at that time the market for such securities did not present a credit risk to Franklin. Also at that time, Franklin began to sell its deep discount GNMA securities, since the Fannie Mae and Freddie Mac securities provided a better investment for Franklin.

19. In 1982 Franklin was initially contracted by the consulting firm of Smith, Breeden & Associates ("Smith, Breeden"). Smith, Breeden instructed Franklin that it could hedge the risk present from the repricing of its liabilities and thus manage the institution's interest rate risk.

20. Smith, Breeden advised Franklin to hedge interest rate risk in the financial futures market. As a condition to receiving advice from Smith, Breeden, Franklin agreed not to enter the financial futures market for purposes of speculation.

21. Franklin initially used Smith, Breeden's services to hedge the maturity mismatch between its assets and liabilities. In this hedging program, if interest rates increased, Franklin would experience gains from its positions in the futures market which would be used to offset its increased cost for funding deposit liabilities at a new higher rate of interest. Conversely, if interest rates declined, the losses suffered in the futures market would be offset by the gains from the repricing of the liabilities.

22. In 1984 interest rates were very high and a demand was created in the market for very long term (longer than 30 years) zero coupon bonds. Since the very long term rates were lower than the 30 year treas-

ury rate, a market opportunity existed for Franklin to issue such long term obligations. Franklin filed an application with the Federal Home Loan Bank Board (the regulatory predecessor of the OTS) to issue such a bond obligation. The application was approved and Franklin issued $2.9 billion in zero coupon bonds.

23. From June 1984 until the spring of 1985, interest rates declined significantly. This decline caused the deep discount assets in Franklin's portfolio to approach par. As a consequence, the prepayment option in the home loan pools owned by Franklin was no longer solely favorable to Franklin. Franklin found itself in a position in which it needed protection from both the risk of increasing and decreasing interest rates. Thus, Franklin took short positions in the futures market, as it had done with respect to the repricing of liabilities, and also took steps to repurchase from the market the prepayment option that the home owner possessed in order to manage the prepayment risk.

24. In an effort to purchase options to hedge the prepayment risk, Smith, Breeden recommended that Franklin purchase current coupon obligations. During 1985, Franklin sold the deep discount loans in its portfolio. Current coupon loans were purchased when Franklin began purchasing put and call options. A put option is the right to deliver a security at a fixed price so that if interest rates go up and the value of the security goes down, Franklin can collect the higher price. A call option gives a party the right to buy an obligation at today's price, even if interest rates decline and the price of the security increases.

25. In December 1985 Dr. Angell determined that Franklin needed to purchase more call options to protect against the possibility of declining interest rates. He reported these findings to Franklin's officers in early 1986.

26. After determining the number of options it needed to purchase to be fully hedged, Franklin learned that if

such options were purchased, Franklin would have virtually no net income for 1986. This finding was consistent with Dr. Angell's findings in the early 1980s that a par value loan cannot be fully hedged by a thrift and produce economic value.

27. After Franklin purchased the options enabling it to be hedged, interest rates went down in early 1986. The options which it had purchased were due to expire in May 1986. Franklin sold these options and realized a gain from these sales. The sales resulted in approximately $140 million in option gains that were recognized at that time and not deferred over future years.

28. In its annual report for the year ended June 30, 1986, Franklin reported the gain from the options' sales under GAAP and noted that the sales distorted the firm's income pattern since it caused an immediately recognized gain which otherwise would have come in ratably over approximately a 7-10 year period.

29. Following the 1986 options sales, Franklin began acquiring longer term assets to match its longer term liabilities. Franklin bought federal agency zero coupon obligations which had maturity dates of approximately the same as the zero coupon bonds issued by Franklin in late 1984. Since these agency obligations were bought and sold in a market at a very tight spread over the U.S. Treasury rate, it was difficult for Franklin to make money on the agency zero coupon obligations. Thus, Franklin sought to replace these obligations with home loan cash flows which could match the interest rate sensitivity of the agency zero coupon bonds.

30. To replace the agency zero coupon bonds, Franklin assembled several hundred million dollars of mortgage backed securities and ultimately issued a one billion dollar collateralized mortgage obligation ("CMO"). A CMO consists of a series of traunches into which home loan cash flows are carved.

31. Some traunches in the CMO represent the early payments that come due on the home loans represented in the CMOs. Other traunches represent the later payments on the home loans. The traunches comprising the earliest payments represent very certain cash flows which can be sold at a very tight spread over the treasury yield curve. The traunches representing the later payments, and which Franklin retained in its portfolio, represent less certain cash flows having a wider spread to the treasury yield curve. Franklin benefited from retaining these later payments because the value sensitivity of these later payments is similar to the sensitivity of the zero coupon obligations which Franklin sought to replace and which matched Franklin's long term liabilities.

32. With respect to the $1 billion CMO, Franklin sold two traunches representing cash flows due during the first four years of the home loans in the CMO. These were sold in the summer of 1986. These early payment traunches accounted for approximately $600 million; whereas the later payment traunches retained by Franklin accounted for approximately $400 million in cash flows.

33. At this same time, Franklin acquired another $1 billion in mortgage backed securities to create and issue another similar CMO. Franklin financed these acquisitions through Merrill Lynch at a short term rate that changed every 30 days. To hedge this financing expense, Franklin sold short positions in the futures market. When Franklin determined that it was not necessary to issue the additional CMO, it sold the billion dollars worth of home loans, closed out the associated liabilities and terminated the short positions. Franklin reported both the gains recognized from the sales and the hedged losses at the same time on its financial statements for the year ended June 30, 1987.

34. In August 1986, FHLBB-Topeka raised various questions concerning the initial CMO issued by Franklin.

At that time, Franklin had planned to issue one CMO each month. While FHLBB-Topeka stated in February 1987 that they were satisfied with the manner in which Franklin nad issued the CMO, Franklin had decided by that time not to issue additional CMOs.

35. Instead of issuing additional CMOs, Franklin determined in 1987 to purchase principal-only obligations. Franklin concluded that these type of obligations better accomplish the intended purpose of a second CMO. A principal-only obligation ("PO") represents the principal payments on a stream of pooled mortgage cash flows.

36. In 1985 Franklin considered entering the business of acting as a retailer for Smith, Breeden's hedging package. Before entering such business, Franklin insisted that the firms to which it would provide counseling service have the same information and software available to them as did Franklin. Smith, Breeden determined that the Smith, Breeden software, then in Franklin's possession, should be returned. After returning the software, Franklin determined that it was uncomfortable operating without knowing the assumptions that were in the software. These assumptions could only be understood by examining the software and having it continually available.

37. In late 1986, Franklin began the search to hire an individual to lead and develop a research division, in house, at Franklin. The research division was to replace the services that had been provided by Smith, Breeden. In the fall of 1987, John Scowcroft began working at Franklin. Mr. Scowcroft had formerly been the head of the research department at Merrill Lynch.

38. Mr. Scowcroft successfully assembled a highly skilled and talented cadre of professionals in Franklin's newly created research department. This department was comprised of individuals having PhDs in finance and economics and MBAs, and having practical experience at

many of the top finance and brokerage firms in the nation. These individuals included Massoud Heidari, who had a PhD from MIT in engineering and who had previously worked at First Boston; Steve Hotopp, who had a PhD from the University of Illinois; and Dick Kazarian, who had a MBA from the University of Chicago and who had worked at Drexell. All these individuals worked on developing Franklin's computer models. Franklin also recruited Liz Kearns, MBA Farleigh, Dickinson University, who had worked at Merrill Lynch and Standard and Poore. Ms. Kearns was hired to work with liability management. Ramine Rouhani, PhD from Stanford in engineering and economics, had worked at Goldman Sachs and CitiCorp, and was hired by Franklin to work with management, hedge analysis and interest rate models. Furthermore, Franklin was successful in recruiting Michael Smirlock, PhD from Washington University, who had been a tenured professor at the Wharton School of Business. Smirlock was in charge of Franklin's asset acquisitions. Also, Franklin hired William Marshall, PhD from Washington University. Mr. Marshall previously had been co-manager of Goldman Sachs's financial strategies group.

39. On June 30, 1987, Franklin acquired the investment banking firm of L. F. Rothschild & Co. This investment was unsuccessful and in 1989 Franklin took steps to close the Rothschild activity. As a result of the L. F. Rothschild acquisition, Franklin experienced a $35-37 million loss for the fiscal year ended June 30, 1989. If not for the one time loss resulting from the L. F. Rothschild investment, Franklin would have reported a profit for fiscal year 1989, rather than a $9 million loss.

B. *Regulatory History Preceding the 1989 Examination*

40. From 1980 through August 10, 1988, Franklin was periodically examined by federal and state regulators. From 1984 through August 10, 1988, the Federal Home Loan Bank Board ("FHLBB") had given Franklin a

composite rating of "2" in each yearly examination. A "2" rating is the normal rating for a safe and sound institution and indicates that the regulators believe that the institution is fundamentally sound.

41. Franklin received a composite rating of "2" on August 5, 1985, even though the amount of futures losses as of June 30, 1985, was slightly greater than the amount of Franklin's capital on that date.

42. At the time of the 1988 Franklin examination, Franklin owned approximately the same amount of mortgage derivative securities as it did on the date of the imposition of the conservatorship.

43. During the course of the 1988 examination, the FHLBB retained as special consultant, Dr. Willliam C. Handorf. Handorf examined Franklin's hedge correlation accounting policy and its application. The policy examined by Dr. Handorf included the absolute value method which had been in effect at Franklin since April 1988. Dr. Handorf issued his report on September 16, 1988.

44. Dr. Handorf concluded that Franklin had implemented "a defensible hedging program." However, Dr. Handorf raised some concerns about the correlation policy Franklin used in its hedge program. Dr. Handorf was somewhat troubled by the seven year assumed life of the assets used in the hedge program. He felt the asset duration was shorter. Dr. Handorf was also troubled by the disallowance of the first month's result in determining hedge correlation. Dr. Handorf's report further concluded that there was no evidence that Franklin was involved in any type of speculation on the futures market. Dr. Handorf summarized his conclusions by stating that the hedging program implemented by Franklin appeared reasonable, and although the method of calculating correlation is generally acceptable, certain rules should be revised. Dr. Handorf recommended that the FHLBB conduct a "limited" or "special" examination prior to the end

of fiscal year 1989 regarding his concerns about the correlation policy.

45. In the fall of 1988, Jerry Mayne, Franklin's chief administrative officer, was contacted by a consultant who had been the executive vice president of the Federal Home Loan Bank of Topeka to determine if Franklin would be interested in bidding on failed thrifts in Missouri. While no Missouri thrift was available for Franklin's bid, the Federal Savings and Loan Insurance Corp. informed Franklin on the possibility of bidding on Beverly Hills Savings & Loan, a failed California thrift. In the fall of 1988, Franklin notified FHLBB-Topeka of its interest in bidding on Beverly Hills Savings & Loan. The Kansas Savings and Loan Department in its exercise of regulatory jurisdiction over Franklin reviewed the intended Beverly Hills' acquisition.

46. Franklin retained the investment banking firm of Goldman Sachs to assist Franklin in reviewing Beverly Hills Savings & Loan in preparation of its bid. In December 1988, Franklin learned from Jay Jupiter, of FSLIC, that FHLBB-Topeka had determined that Franklin was not a qualified bidder for the Beverly Hills institution. FHLBB-Topeka had withdrawn its approval of Franklin as a qualified bidder for Beverly Hills Savings & Loan. In January 1989, representatives from Franklin met in Washington, D.C., with FHLB representatives, including Tommie Thompson and Darrell Dochow. At that meeting, Franklin stated that it would resolve any of the regulator's concerns if FHLB would allow Franklin to go ahead and acquire Beverly Hills. FHLB incorrectly interpreted Franklin's offer to resolve differences as a sign of desperation.

47. Immediately following the Bevery Hills episode, the Office of Regulatory Actitvities ("ORA") of FHLBB in Washington, D.C., generated a list of hedge accounting issues concerning Franklin. The FHLBB ultimately pur-

sued only one of these issues, the issue concerning the hedge accounting by Franklin for its zero coupon bonds.

48. The chief accountant's office of FHLBB in Washington conducted an extensive follow-up on Dr. Handorf's report and examined Franklin's accounting practices. FHLBB accounting fellow, Julie Gerschick, prepared draft reports to Tomime Thompson of FHLBB-Topeka raising various questions.

49. The Topeka regulators elected to pursue two issues with Franklin. One involved the amortization period for futures gains and losses and the other involved amortization of hedge losses on zero coupon bonds.

50. Ultimateiy, the issue which the regulators pursued against Franklin was the hedge accounting for zero coupon bonds. This issue was resolved for all practical purposes in Franklin's favor.

51. After December 1988 and the failed attempt to acquire Beverly Hills Savings & Loan, Franklin began a series of monthly meetings with federal regulators. Franklin proposed these meetings in order to keep the regulators up to date on what Franklin was doing and so that Franklin could hear any regulatory concerns.

52. In early 1988 Franklin began discussions with Goldman Sachs to explore raising additional capital. Franklin sought this additional capital to obtain a very high interest grade rating. Because of adverse regulatory action against Franklin in connection with the Beverly Hills' matter, and because of the pending FIRREA legislation, Goldman Sachs advised that it would be highly unlikely that Franklin could raise the desired additional capital during that year.

53. In the spring of 1989, Franklin decided that it would reduce its size by approximately $5 billion so that it could achieve an 8 percent capital level which was necessary to obtain a high investment grade rating.

54. Following the resolution of the hedge loss amortization issues on the zero coupon bonds following the 1988 examination, OTS-Topeka wrote a letter to Franklin stating that it still had concerns about certain aspects of its hedge accounting program. This letter caused Franklin and its outside auditors to be concerned about Franklin's annual report (Form 10K) for the fiscal year ended June 30, 1989.

55. After many discussions, Louis V. Roy, deputy district director of OTS-Topeka, wrote Franklin on September 27, 1989, and stated that OTS was not in a position to make supervisory objections to Franklin's hedge accounting practices at that time. His letter stated that OTS "will continue to review and analyze Franklin's hedge accounting practices in the future." Franklin considered this statement to be consistent with OTS's ongoing regulatory duties and not a statement that any issues remained open. Mr. Fleischer understood this letter, together with the 1988 examination of Franklin, as indicating that as of September 1989 OTS had no legitimate concerns regarding Franklin's past accounting practices.

C. *The Regulatory Examination of October 1989 Through February 1990.*

56. Commencing October 16, 1989, a concurrent joint regular examination of Franklin Savings Association was conducted by the OTS, KSLD and the Federal Deposit Insurance Corp. (FDIC).

57. In late 1988 some members of the FHLBB-Topeka staff were highly criticized for their handling of Silverado Savings & Loan, a Colorado thrift, and were informed by Chairman M. Danny Wall that their jobs were in jeopardy if their performance did not improve. Some of these same individuals were later involved in the October 1989 Franklin examination.

58. The analyst in charge of Silverado, Thomas O'Rourke, was assigned to work full time on the Franklin examination and matters relating to Franklin beginning July 1, 1989.

59. Mr. O'Rourke noted that Franklin had in its portfolio similar assets to those formerly held by Silverado. This similarity probably slanted Mr. O'Rourke's view against Franklin and Franklin's system of operations.

60. Mr. O'Rourke reviewed and read Franklin's Form 10K (annual report) for the period ended June 30, 1989. Mr. O'Rourke had previously read only one Form 10K and was unaware of the disclosures required in such a document. O'Rourke misperceived the cautionary disclosures of "material adverse risk" in the Form 10K as projections that the institution would experience difficulties. However, Franklin made these disclosures to fulfill its duty under federal securities laws. Such disclosures were included in earlier 10Ks filed by Franklin. After reviewing the Form 10K, Mr. O'Rourke drafted a memorandum changing Franklin's internal OTS classification from "healthy" to "marginal."

61. The disclosures presented in Franklin's 10K for the period ended June 30, 1989, were proper. The conclusions O'Rourke and OTS reached after reviewing the 10K, that the risks disclosed were likely or probable to occur, were arbitrary and capricious and without reasonable basis.

62. Members of the OTS-Topeka staff appeared to lack adequate training and understanding to evaluate the nature of Franklin's operation. The written analyses and memoranda prepared by the Topeka staff, including portions of Franklin's report of examination (Administrative Record Document 36), Mr. O'Rourke's review of Franklin's Form 10K (Exhibit 825), and the recommendation memo ("S Memo") dated February 12, 1989 (Administrative Record Document 6, also in evidence as Exhibit

469), contained fundamental factual errors as well as material errors of interpretation and analysis.

63. During the course of the 1989 examination, Franklin cooperated fully with OTS regarding each general and specific request for information.

64. On November 3, 1989, OTS-Topeka provided Franklin with a supervisory directive, which Franklin fully responded to by letter dated December 19, 1989. (Exhibits 314, 598). This December 19, 1989, letter was not made part of the administrative record designated by OTS.

65. On December 21, 1989, members of the OTS-Topeka staff met with Franklin representatives and informed Franklin that the OTS had calculated that Franklin must take approximately $248 million in capital write-downs because Franklin had inappropriately deferred that amount of hedging losses. At that meeting, OTS provided Franklin with a document entitled "Hedge Correlation Analysis Methodology" which set forth the way in which OTS had reviewed Franklin's hedges.

66. Franklin's hedge correlation policies were discussed between representatives of OTS, FDIC, Franklin and Deloitte and Touche at the January 8, 1990, examination exit conference; a meeting held on January 18, 1990; and a meeting held on February 8, 1990. The OTS, however, rejected all the justifications Franklin offered for its hedge correlation policy and reaffirmed its tentative conclusion that a large capital adjustment must be made regarding this issue.

67. At the time OTS presented the "Hedge Correlation Analysis Methodology" document to Franklin, representatives from OTS informed Franklin that OTS had recalculated Franklin's hedge correlation using the methodology described in the hedge accounting memorandum. (Pretrial Order stipulation (j)). The "Hedge Correlation

Analysis Methodology" document was not included in the administrative record. (Pretrial Order stipulation (k)).

68. In January 1990 Louis Roy informed Franklin that its proposal for reducing its portfolio of TB 12 assets as outlined in Franklin's December 19, 1989, letter was unsatisfactory. In response to this statement, Franklin prepared a letter dated February 8, 1990, outlining in detail the sensitivity of Franklin's TB 12 assets portfolio, as well as Franklin's proposal to reduce the size of its TB 12 portfolio and total assets over the coming months. (Exhibit 316.) This February 8, 1990, letter was not made a part of the administrative record designated by OTS. This letter indicates that OTS should have known that Franklin could have remained in compliance with all regulatory capital requirements, even if the financial statement adjustments ordered by OTS were ultimately upheld.

69. On January 8, 1990, representatives from OTS, KSLD and FDIC met with Franklin representatives to conduct an examination exit conference, as stated above. At this conference, OTS informed Franklin of the examination's preliminary results. Franklin would be required to make write-downs for inappropriate hedge accounting, and for improper over-valuation of property involved in Franklin's credit enhancement program. The OTS alleged that Franklin would fail its regulatory capital requirements as a result of these write-downs. Franklin resisted the proposed write-downs contending that the write-downs were invalid and lacked legal or factual basis.

70. Following the exit conference, Franklin's chief financial officer, Dennis Katzer, reviewed Franklin's bond indentures to determine if there were any problems. On January 11, 1990, Franklin informed OTS of the possibility of collateral substitution or legal defeasance of certain zero coupon bonds if the contested adjustments were ultimately upheld.

71. Prior to January 11, 1990, OTS had engaged in discussions with Franklin management with respect to the imposition of an individual minimum capital requirement ("IMCR") for Franklin. (Pretrial Order Stipulation (n)). OTS's consideration of an IMCR for Franklin ceased sometime after Franklin's disclosure of the potential bond defeasance. (Pretrial Order stipulation (o)). Upon learning of the potential bond defeasance, OTS's internal classification for Franklin changed from "distressed" to "resolution I." (Pretrial Order stipulation (p)).

72. On January 22, 1990, Franklin met with OTS representatives to discuss OTS's apparent inaction with regard to various issues raised by the examination and to present OTS with certain alternative courses of action. Franklin did not at this meeting or any subsequent time consent to an appointment of a conservator or receiver.

73. Mr. Fleischer's draft letter of January 22, 1990 (Exhibit 623), does not evidence any consent to a conservatorship or receivership. The draft letter simply was used to discuss all possible outcomes. This draft letter was not part of the administrative record. Moreover, the legal memorandum ("L-memo") (Administrative Record Document 3) shows that OTS expected litigation if a conservator was appointed. The legal memorandum indicates that OTS knew Franklin had not consented to such an appointment. The legal memorandum stated: "OTS/legal believes that there may be a challenge to the proposed transaction."

74. The recommendation memo, or "S-memo," (Administrative Record Document 6) went through several drafts before the final form was executed. The draft preceding the final version was changed, on specific advice and instruction of OTS-Topeka district counsel, Brian McCormally. McCormally indicated that it was necessary to "point the finger" at Franklin's management. *See*

handwritten instruction on Exhibit 826, p. 33 (T0026063). No factual or legal basis exists for McCormally's instruction. This action is indicative of arbitrary, capricious and unreasonable conduct.

75. On February 14, 1990, Franklin issued its Form 10Q (Quarterly Report) for the quarter ended December 31, 1989. Prior to issuing this Form 10Q, Franklin provided it to OTS for review. OTS reviewed and discussed this Form 10Q with Franklin before it was filed. (Pretrial Order stipulation (r)). The Form 10Q clearly states that Franklin believed that OTS's proposed adjustments were not valid and that Franklin intended to oppose those adjustments by "all appropriate means." (Exhibit 624, p. 20.) The Form 10Q was not a report of capital failure and did not trigger any collateral substitution or legal defeasance remedies for the bond trustee under the indenture for the zero coupon bonds.

76. The OTS had initially scheduled to appoint the conservator for Franklin on February 14, 1990. OTS had scheduled a meeting with Franklin's board of directors for that date to provide the report of examination and to impose the conservatorship. On February 13, 1990, OTS director M. Danny Wall decided to impose a conservator for Franklin, but decided to postpone the takeover until after the release of Franklin's Form 10Q.

77. At the direction of Director Wall, the Franklin board meeting was rescheduled for February 16, 1990. At this meeting, OTS presented Franklin with the report of examination and informed Franklin that a conservator had been appointed for Franklin.

78. On February 14, 1990, Mr. Fleischer had spoken with a representative of the bond trustee, IBJ Schroder, concerning whether the publication on that day of Franklin's Form 10Q would constitute an event of default triggering the collateral substitution or legal defeasance provision of the bond indenture. The representative of IBJ

Schroder informed Fleischer that the Form 10Q did not constitute an event triggering the default. During this conversation, the IBJ Schroder representative and Fleischer further discussed the possibility of a bond exchange which would in any event avoid or greatly lessen the loss from any collateral substitution or legal defeasance.

79. The following day, February 15, 1990, Mr. Fleischer informed Thomas O'Rourke of the conversation with IBJ Schroder, and that the bond trustee was of the view that the Form 10Q did not constitute an event triggering default and also of the possibility of a bond exchange. Mr. O'Rourke was instructed by OTS district counsel McCormally not to follow-up on this information.

80. OTS had no contact, no conversation, and no correspondence with the bond trustee concerning any matter arising in connection with the zero coupon bond indenture prior to February 16, 1990. (Pretrial Order stipulation (t), (u) and (v)). Also, OTS did not contact the bond trustee to inquire whether any event had occurred or was about to occur that would trigger the collateral substitution or legal defeasance of the bonds. (Pretrial Order stipulation (w)).

81. At the February 16, 1990, board of directors meeting, OTS district counsel Brian McCormally informed Franklin that OTS's outside counsel had provided an opinion that the Form 10Q as published and the report of examination constituted an event of default allowing the bond trustee to begin collateral substitution or legal defeasance. This was erroneous.

82. No formal administrative hearing was held prior to the appointment of the conservator. (Pretrial order stipulation (h)).

83. Following the imposition of the conservator, OTS sent a letter, dated February 20, 1990, directing RTC/Franklin to make a $119 million write-down for inappropriate deferred hedging losses, a $46 million write-down

due to inadequate valuation allowances for properties involved in Franklin's credit enhancement program, and a $185 million write-down on the basis that the bond defeasance was an event likely to occur. The RTC did make the $119 million and the $46 million write-downs. The RTC, as conservator for Franklin, at that time and subsequent times, resisted the proposed bond defeasance write-downs as not appropriate in view of its power under FIRREA to repudiate the bond indentures. Franklin has never filed a report showing capital failure, and thus bond defeasance has never been an event likely to occur prior to the takeover of Franklin.

84. Following the OTS's February 20, 1990, directive concerning the hedge accounting and credit enhancement write-downs, Franklin nonetheless had the means to comply with all regulatory capital requirements through transactions already scheduled to occur. Exhibit 603 is a table showing Franklin's available means to meet or exceed all regulatory capital requirements after the first wave of adjustments.

85. The Savers Life intangible asset indicated in the table on Exhibit 603 relates to the purchase by Franklin subsidiary Savers Life Insurance Company of a block of insurance policies from Sun Life Insurance Company. The court finds that this intangible asset may be properly included in Franklin's capital because it meets the three requirements set out in 12 C.F.R. § 567.5(a)(2)(ii). First, the intangible asset is capable of being sold apart from Franklin's and Savers Life's other business. Second, a market clearly is established annually through an identifiable cash flow stream for the assets acquired. The market value of the cash flow stream is not in any way dependent on the future prospects of Franklin, and indeed the cash flow stream from Savers Life intangible bears no relationship to Franklin's other activities. Finally, a large market exists for blocks of insurance poli-

cies making this asset liquid. *See* Conclusion of Law No. 10.

86. Franklin properly included in its capital this amount of its investment in its Savers Life subsidiary, even though it was engaged in an activity not permitted for national banks. The amount of Franklin's investment in its Franklin Financial Services ("FFS") subsidiary in October of 1989, which was used to fund Savers Life's purchase of the block of insurance policies, did not exceed Franklin's investment in and extension of credit to FFS as of April 12, 1989. Based on applicable law, this asset was properly included in Franklin's capital. *See* Conclusion of Law No. 11.

87. The "sale of assets" referred to in Exhibit 603 was a step which Franklin could take to meet capital requirements after the first wave of adjustments and was explained to OTS prior to the conservatorship in attachments to Mr. Fleischer's letters of December 19, 1989, and February 8, 1990.

88. On March 7, 1990, the RTC recorded some of the accounting adjustments set forth in OTS's February 20, 1990 directive. (Pretrial Order stipulation (af)). OTS learned that since RTC refused to make all the adjustments set forth in the directive, Franklin would significantly fail only one of the three capital requirements imposed on Franklin by FIRREA and OTS regulations (tangible capital, core capital, and risk base capital). (Pretrial Order stipulation (ag), (ah), Exhibits 633, 686).

89. On or about March 8, 1990, OTS reviewed four alternative hedge accounting adjustments for Franklin. (Pretrial Order stipulations (ai)).

90. Prior to the imposition of the conservator, OTS had considered the four alternative hedge accounting adjustments which it reviewed again on March 8, 1990. (Pretrial Order stipulation (aj)). OTS Topeka apparently

chose one of the four additional options prepared by Mr. Benson and considered it a "safety and soundness" concern to effect extra write-downs to its concern about historical asset sales. The option selected was basically a disallowance of the "six month grace period feature" of Franklin's hedge accounting policy. *See, infra,* Finding of Fact No. 116.

91. On March 8, 1990, OTS was informed by facsimile transmission that Franklin had available the means to meet regulatory capital requirements, even if the hedge accounting and credit enhancement write-downs were valid and that RTS was preparing to announce publicly that Franklin was a solvent institution. On the following day, March 9, 1990, OTS imposed a second wave of adjustments consisisting of an additional $61.9 million (later corrected to $51.9 million) (Exhibit 132) "safety and soundness" hedge accounting write-down and a write-down of $110 mililon relating to the tax agreements entered into between Franklin and FSC. The court finds that this second wave of adjustments imposed on March 9, 1990, was arbitrary and capricious and lacked any reasonable basis.

92. In view of the invalidity of OTS's proposed write-downs, Franklin exceeded all three regulatory capital requirements on December 31, 1989.

93. In view of the invalidity of OTS's proposed adjustments, Franklin exceeded all three regulatory capital requirements on March 31, 1990.

94. On June 1, 1990, OTS Director T. Timothy Ryan issued a "ratification and appointment order," which attempted to ratify the initial conservator appointed on February 15, 1990, and to appoint a new conservator based on an expanded administrative record. This court has determined that the purported ratification and appointment of a new conservator was invalid. *See* Memorandum and Order of June 22, 1990.

D. *OTS's Directed Write-downs for Deferred Hedging Losses*

95. At all times relevant to the October 1989 examination, Franklin was a liability hedger. On June 30, 1989, Franklin switched to operating as an asset hedger. As a liability hedger, Franklin deferred its gains and losses on its futures positions. The regulators initially became concerned with Franklin's hedge accounting program due to the significant increase in the amount of deferred hedging losses. During the 1988 exam, the Federal Home Loan Bank retained Dr. William C. Handorf to review Franklin's hedging program and method of accounting. Dr. Handorf's report is discussed, *supra.*, in Findings of Fact Nos. 43 and 44.

96. After reviewing plaintiff's hedging program and policies during the October 1989 examination, OTS directed that $119 million of hedged losses be written down and recognized. OTS ordered these write-downs because certain aspects of Franklin's hedge accounting policy was not in accordance with GAAP according to OTS. Specifically, OTS determined that the write-downs were necessary because this amount of losses has been inappropriately deferred under Franklin's absolute value method of determining correlation and because of Franklin's inappropriate use of nonparallel shifts in the yield curve as unusual events to justify continuation of deferral accounting when correlation failed. Later, during the second wave of write-downs, which OTS directed against RTC/Franklin on March 9, 1990, OTS ordered an additional write-down and recognition of $51.9 million of deferred losses for safety and soundness reasons. Specifically, OTS found that Franklin's use of the six month initial grace period in its correlation determination policy to be an unsafe and unsound practice. Also, OTS was troubled by the $150,000 materiality factor and the rolling 12 month period of measuring correlation and substantial offset.

97. Regarding the accounting issues and matters raised in this case, this court finds that the testimony of Chester B. Vanatta to be credible and helpful to the court. Mr. Vanatta, a CPA, is a former managing partner of Arthur Young & Company and an experienced professional in general financial accounting. Mr. Vanatta has also lectured at the University of Kansas School of Business. The court finds Mr. Vanatta to be highly qualified to provide expert opinion concerning Statement No. 80 of the Financial Accounting Standards Board ("FAS 80") and its application to Franklin's deferral accounting procedures. Mr. Vanatta testified that Franklin's accounting treatment of its hedging program was in accordance with FAS 80 and with GAAP.

98. Also, the court finds that Professor Richard Leftwich was a credible witness and highly qualified to provide expert opinion testimony in the area of finance accounting. Professor Leftwich, a CPA, is a professor of accounting and finance at the graduate school of business of the University of Chicago. He has taught MBA courses in portfolio and risk management. Professor Leftwich testified that Franklin's hedges were working economically to reduce the institution's exposure to interest rate risk, and that the hedges were demonstrating high correlation and substantial offset, and that Franklin's accounting methods satisfied GAAP.

99. The court finds the testimony of John Smith, partner in the national office of Deloitte and Touche to be credible concerning hedge accounting.

100. Also, the court finds that Mary Standler, a CPA and former manager of financial reporting for Franklin, and Mark Woodward, comptroller at Franklin, were very credible witnesses. These witnesses were very knowledgeable in the field of finance accounting and with regard to deferral accounting under FAS 80.

101. The court gives little weight to the tesimony of Alfred Schrott, a CPA and partner in the accounting firm

of Spicer and Openhiem. Mr. Schrott testified that all challenging provisions of Franklin's hedge accounting policy were not in accordance with GAAP. Mr. Schrott had an extremely conservative view of GAAP regarding hedge accounting. Mr. Schrott's testimony was contradicted by the other more persuasive and credible expert witnesses. Moreover, Mr. Schrott had difficulties even with the method used by OTS to calculate the $119 million write-down.

102. Hedge or deferral accounting is the subject of considerable debate and a wide diversity of opinion in practice throughout the United States. The general guidelines for deferral accounting are set out in FAS 80. The application of the general guidelines set forth in FAS 80 to a particular institution requires a substantial amount of informed judgment on the part of the institution's management and its independent outside auditor. If a hedging transaction meets the general criteria set forth in FAS 80, gains or losses on the hedging transaction are deferred, instead of being currently recognized. The deferred gain or loss is amortized into the income statement over the life of the hedged item.

103. Franklin designated its hedged positions against the future repricing of short-term liabilities.

104. As a prerequisite to deferral accounting, FAS 80 requires that an enterprise interest rate risk exist. It is undisputed that Franklin properly identified and measured its enterprise interest rate risk as required by FAS 80.

105. As a prerequisite to deferral accounting, FAS 80 requires that a transaction be designated as a hedge at the time of its inception. This designation process serves to impose a discipline on the entity so that the decision whether to defer or recognize a currently hedged gain or loss will not be made after the entity observes the results of the transactions.

106. FAS 80 requires "high correlation" of the changes in the market value of the futures contracts and the value of the hedged items at the inception of the hedge and throughout the life of the hedge. FAS 80 requires that the results of the futures contracts "substantially offset" the effects of price or interest rate changes on the exposed item. Paragraph 4(b) of FAS 80.

107. FAS 80 requires "high correlation" between gains or losses on the hedging instrument and the gains or losses on the hedging instrument and the gains or losses no the futures contracts. If high correlation has not occurred, the entity must cease deferral accounting and recognize a gain or loss to the extent the futures results have not been offset by the effects of price or interest rate changes on the hedged item. Paragraph 11 of FAS 80.

108. The hedge accounting issue in this case boils down to whether Franklin's policy and procedures for ascertaining the existence of high correlation and substantial offset in past periods on an ongoing basis are appropriate implementation of the general guidelines of FAS 80, in accordance with GAAP.

109. A deferral or hedge accounting practice need not be widely used in practice to be in accordance with GAAP as long as it is in accordance with FAS 80.

110. Based on the evidence presented, this court is convinced and finds that the hedge accounting policies dated June 30, 1988, and December 31, 1988, are consistent in all material effects and are in accordance with GAAP.

111. Since Franklin began using hedge accounting, its hedge accounting policy has been approved by its outside independent auditors, which includes the firms of Deloitte, Haskin, & Sells; Touche, Ross & Co.; and Deloitte & Touche.

1. *Franklin's Hedge Correlation Policy.*

112. Franklin's hedge correlation policy evolved over a period of time as the institution gained more experience and expertise in its hedging program and in the economic analysis of that program. Franklin did not develop its policy to create a biased view toward achieving maximum deferral. Franklin's desire in developing its correlation policy was to reflect the economic reality inherent in the hedging transaction. Franklin was rather unique since it memorialized its policy in writing.

113. Implementation of the Franklin hedge correlation policy involved a series of steps through which the accounting department ran each hedge on a monthly basis. The first step in the analysis is the initial correlation analysis based on the use of Franklin's absolute value method and using a rolling 12 months of data. Gains or losses on futures transactions are divided by gains or losses on the liabilities to determine whether an acceptable correlation ratio has been achieved. This is the process by which Franklin measured high correlation and substantial offset.

114. If the ascertained ratio falls within a band of −80 to −125 percent, the hedge is deemed to be in high correlation and to have achieved substantial offset. If the hedge had not failed correlation in a prior period, the gain or loss on the futures contract is then deferred and amortized. The gain or loss which is deferred and amortized reflects the actual results of the futures transaction. Absolute values are used only for the purpose of determining correlation and not for the purpose of recording the results of the futures transactions on Franklin's books and records or in its financial statements. If a hedge has failed in prior periods, deferral accounting would occur only if the hedge had been restructured.

115. OTS has concluded that correlation ratio within the range of −70 to −130 percent constitutes sufficiently high correlation for deferral accounting under FAS 80.

116. If after making the initial computation, the offset ratio obtained is outside the −80 to −125 percent correlation band, several steps occur in Franklin's analysis. If the hedge has not been in place for six months, a decision on whether to recognize or defer gains or losses is postponed until the end of the six month initial period. This is what has been called the six months initial grace period. In view of the anticipated seven year repricings of the hedged items, a six month period is reasonable and necessary to obtain a reliable data base for judging the hedge's effectiveness. If a hedge was indicating poor correlation in the first six months, Franklin's accounting department would consult with its treasury department about restructuring or terminating the hedge. If a hedge is terminated before the end of six months, all futures gains or losses in excess of the liability gains or losses are recognized currently and the balance is deferred. This recognizes that the hedge did achieve some offset on the hedge item and that it had a high probability of future correlation at the time the hedge was established.

117. If a hedge fails correlation and has been in existence for more than six months, the determination then is made about whether the amount of noncorrelation exceeds $150,000. If the amount of noncorrelation is less than $150,000, the hedge is deemed to be sufficiently correlated to permit continued deferral accounting. This aspect of Franklin's policy addresses the question of materiality, an overriding consideration under GAAP. Franklin analyzed this feature of the policy for OTS during the regulatory examination and demonstrated that its application did not provide material distortions in Franklin's financial statements in prior periods. This analysis was provided to OTS, but was excluded from the administrative record. This provision of Franklin's correlation policy has been referred to as the $150,000 materiality factor.

118. If a hedge fails correlation and is older than six months and the amount of the correlation exceeds $150,000,

the next step in Franklin's analysis determines whether the first month of the hedge caused the noncorrelation. Hedges often require some period of time to perform adequately. Franklin's policy makes allowance for the fact that a hedge may be put on late in a month and not have a full 30 days worth of performance to adequately judge correlation. If correlation failure is attributable to the first month performance, Franklin does a top-off adjustment, that is, Franklin recognizes gains and losses on the futures in excess of gains and losses on liabilities currently and defers the balance. Thereafter, the first month is excluded in subsequent correlation analysis. This provision of the policy has been referred to as the first month disallowance provision.

119. If the hedge fails correlation, is older than six months, and if the correlation failure is material and not attributable to the first month, Franklin's policy next requires a determination of whether unusual economic or market conditions caused the adverse correlation ratio. Under Franklin's policy, if noncorrelation is attributable to a month in which there has been a nonparallel shift in the yield curve, a top-off adjustment is made and deferral accounting is continued for the balance with the failure month disregarded in subsequent analysis. This provision has been referred to in various ways, including the nonparallel shift in the yield curve, or curve inversion, provision, or explainable event, or unusual event, provision.

120. If a hedge has failed correlation under Franklin's policy, futures gains and losses in excess of liability gains and losses are recognized currently in income. If the futures gains and losses are less than the liabilities gains and losses, no current recognition is appropriate because there has been some offset and the high probability in inception criteria has been met. There is no dispute in this case over this feature of Franklin's policy.

121. Franklin's hedge accounting policy was initially put into operation in late March or April 1988. Certain

refinements in the correlation policy have been made since that time. However, these changes or refinements were not made for the purpose of maximizing deferral, but instead were made to more accurately reflect the economic reality underlying the hedge program.

122. In imposing the conservatorship on Franklin, OTS challenged primarily two aspects of Franklin's hedge accounting policy: (1) the absolute value technique for measuring correlation and substantial offset; and (2) the treatment of a nonparallel shift in the treasury yield curve as an explainable or unusual event justifying continuation of deferral accounting when correlation fails for that measuring period.

2. *The Absolute Value Method.*

123. Franklin started using the absolute value method of determining correlation in late March 1988. Franklin began using this method after it discovered that the cumulative net dollar offset method failed some hedges that, in fact, had high correlation. OTS used the dollar offset method to calculate the directed $119 million write-down for inappropriate deferred losses [10].

124. The absolute value method and the dollar offset ratio method generally produce similar correlation ratio results as long as interest rates move in one direction during a measuring period. If, however, the interest rates change directions during the measuring period, as frequently occurs, some changes in the values of the fu-

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[10] Initially, the dollar offset calculation determined that $248 million in losses were wrongly deferred. The OTS modified this method by making allowances for what it called the "whip saw effect." OTS contends that this modification accounts for the dollar offset ratio method's shortcoming which results when the actual gains and losses approach zero. This "whip saw effect" adjustment resulted in a $37 million reduction to the original adjustment. After some additional corrections were made in the adjustments, OTS arrived at a figure of $119 million for what it considered inappropriately deferred losses.

tures and liabilities, which offset each other, will nonetheless produce unacceptable correlation ratios if the dollar offset method is used. Thus, the actual economic nature of the hedge is not correctly reflected.

125. In general, implementation of the absolute value method occurs in any month in which the change in value of the futures transactions and the change in value of liability gains or losses in fact offset each other. If there are gains in both transactions or losses in both transactions, Franklin uses actual numbers. However, if the two sides of the hedge actually offset each other, absolute values are used so that all numbers for futures transactions are designated negative and all numbers for liability repricings are designated positive, for the sole purpose of measuring correlation. This approach allows the institution to ascertain whether the hedge is, in fact, working in a changing interest rate environment and requires that correlation actually reflect the underlying economic reality, which sometimes does not occur in the dollar offset method. The absolute value method compares the total movement in the value of the futures transactions and in the liabilities gains and losses.

126. When interest rates move in the same direction during a measuring period, both the dollar offset method and the absolute value method generally produce the same result in analyzing hedge correlation. The following table, using hypothetical numbers, illustrates this result:

	Futures Hedge	Hedged Item	Absolute Value	OTS Dollar Offset
1st mo.	+60	−50		
2d mo.	+40	−40	−90% Correlation	−90% Correlation
	100	−90		

127. When interest rates change directions during the measuring period, the dollar offset method has the effect of disqualifying many hedges which in fact show high cor-

relation. The following table comparing the absolute value and dollar offset methods illustrates this result:

DOLLAR OFFSET METHOD

	Futures Hedge	Hedged Item	Correlation Ratio
1st mo.	+60	−50	
2d mo.	−40	+40	−50% Correlation
	20	−10	

ABSOLUTE VALUE METHOD

1st mo.	−60*	+50*	
2d mo.	−40	+40	−90% Correlation
	−100	90	

* absolute value designation

Under the dollar offset method, which compares the net change in the futures and hedged item positions, the hedge fails correlation even though for each individual month involved the ratio between the futures item and the hedged item shows high correlation and substantial offset. Under the absolute value method, whenever offset exists (*i.e.*, the hedge moves in one direction and the hedged item moves in the opposite direction), a negative value is assigned to all changes in the futures position and a positive value is assigned to all changes in the hedged item. By changing the signs in this manner, the absolute value method measures the strength of the relationship between the hedge and the hedged liabilities, without regard to the shifts in the direction of interest rates during the measuring period. Franklin's method of determining high correlation is more in accordance with economic reality than the dollar offset method used by OTS. The hedge is performing its economic function, for changes in liability values are substantially offset by gains and losses on the hedge.

128. After considering the analyses and testimony of the various experts and the explanation of Franklin's ap-

plication and use of the absolute value method, brought out in the testimony of Ernest Fleischer, Mary Standler, and Mark Woodward, the court finds that Franklin's use of the absolute value method is a reliable method of testing correlation, which accurately measures high correlation and substantial offset as required by FAS 80.

3. *Nonparallel Shifts in the Treasury Yield Curve as Unusual Events.*

129. Most accounting practitioners agree that a hedge should not be disqualified or that deferral accounting should be discontinued based solely on an isolated unusual event. Franklin's hedge correlation policy permitted monthly activity to be disregarded in subsequent correlation analysis if a nonparallel shift in the treasury yield curve caused the noncorrelation for that month. *See, supra.*, Findings of Fact No. 119.

130. OTS has taken issue with this portion of Franklin's hedge correlation policy and has determined that it is not GAAP, and therefore, its use to be a violation of OTS regulations. OTS used this decision, in addition to its disapproval of the use of the absolute value method, to justify its ordered GAAP write-downs regarding the deferred hedging losses.

131. The court finds that plaintiffs have established that the use of nonparallel shifts in the yield curve as unusual events in Franklin's correlation policy is a reasonable application of FAS 80 and accords with GAAP. This finding is based on the fact that this provision of Franklin's policy was certified by its independent accountant, Deloitte and Touche, and the testimony of credible and reliable expert witnesses.

4. *Safety and Soundness Write-downs Regarding Hedge Accounting Policy.*

132. In a letter dated March 9, 1990, OTS ordered RTC/Franklin to record a second wave of hedge accounting adjustments in the amount of $61.9 million (later cor-

rected to $51.9 million). This second wave of hedge accounting adjustments was based on "safety and soundness" concerns and not GAAP requirements.

133. These safety and soundness write-downs for hedging losses primarily result from OTS's decision that the six month initial grace period provision of Franklin's hedge accounting correlation policy is an unsafe and unsound policy. OTS criticized other elements of the hedge correlation policy as unsafe and unsound, including the rolling 12-month data provision and the use of the $150,000 materiality provision. These provisions are discussed in detail, *supra.*, in Findings of Facts Nos. 116-119. OTS believed that the use of these provisions of the policy allowed improper deferral of losses.

134. On March 8, 1990, OTS was informed by RTC that even after the initial write-downs (excluding the bond defeasance write-down which RTC refused to make), Franklin was still solvent and could meet its tangible capital requirement. The next day OTS ordered the second wave of adjustments. It appears that the second wave of adjustments was an attempt by OTS to justify its earlier appointment of the conservator.

135. The expert opinion evidence presented in this case clearly convinces the court that the challenged provisions of the Franklin's correlation policy are safe and sound practices. OTS acted in an arbitrary and capricious manner and without reasonable basis in directing this second wave of write-downs relating to the hedge accounting policy.

5. *Other Safety and Soundness Concerns Regarding Franklin's Hedge Program.*

136. In addition to concerns about the method of accounting for deferred hedging losses, the regulator also expressed concern about the overall level of deferred losses acquired by Franklin, the recognition of gains from the

sales of assets, and whether such sales affect the deferral of future losses.

137. During the quarter ended June 30, 1989, the amount of Franklin's deferred losses increased substantially. This significant increase, however, primarly resulted from a 150 basis point drop in interest rates during that time period.

138. These additional deferred losses will be offset by repricing gains to occur in the future. The amount or level of deferred hedging losses incurred by Franklin have not been shown to present any safety or soundness issue as long as the offsetting gains are in place. Neither the level nor the amount of deferred hedging losses have been shown to create any legitimate safety or soundness concerns.

139. Franklin's hedging program has not caused any economic losses to the institution.

140. There exists no relationship between the accounting gains on sales of assets and the amount of Franklin's deferred hedging losses. The court finds OTS's unsupported assertions to the contrary to be without reasonable basis.

141. Between June 30, 1984, and September 30, 1989, Franklin sold investment securities and options and recorded $429.8 million in gains on these sales.

142. Franklin has shown that there is no relationship between these sales of assets and any futures transactions. These sales did not trigger a recognition of deferred losses.

143. Gains on anticipated liability repricings have not been realized by historical asset sales. Exhibit 604 illustrates that asset sales have not detracted from Franklin's anticipated repricing gains. Most of these asset sales involve: (1) assets for which no future contracts were shorted at the time of acquisitions; (2) assets whose sale

was accompanied by a write-off of deferred hedge losses because both were held in a subsidiary; and (3) assets whose disposition and associated deferred hedge losses were examined and approved by the regulators in 1985.

144. Franklin was not dependent on gains from the sales of assets to conduct profitable operations. For each year from June 30, 1983, through December 31, 1989, Franklin had net income after taxes, with gains and losses from sale of assets and discontinued operations excluded.

E. *OTS's Write-downs Regarding Credit Enhancement Program.*

145. One of the regulator's basis for the imposition of the conservator was OTS's conclusion during the examination that additional $46.9 million valuation allowances in loss reserves should be established for Franklin's credit enhancement program. Franklin had previously established $19 million in loss reserves for this program.

146. The basic dispute between the regulator and the institution regarding the credit enhancement program was whether the value of available favorable financing on these projects should be included as part of the value of the credit enhancement properties. Franklin contended that the appropriate amount of loss reserves should take into consideration the value of favorable financing on these properties. OTS concluded that the existence of favorable financing could not be considered in determining the amount of necessary reserves. (Testimony of Bruce Benson, T. 3080; testimony of Kurt Schoeb, T. 2422).

147. Franklin's credit enhancement program involves transactions in which Franklin would issue letters of credit to enhance the investment rating of tax exempt variable rate bonds which had been issued by a governmental entity. The proceeds of these bonds were loaned to developers to construct or rehabilitate multi-family

residential real estate. Franklin issued irrevocable letters of credit to the bond trustees guaranteeing timely payments on the bonds. In exchange for Franklin's issuing the letters of credit of guaranteeing the payments to the bond holders, the project developer agreed to reimburse Franklin for all payments made under the letter of credit. The developers provided a fixed rate of interest on its obligation to Franklin, and also paid monthly fees to Franklin. Franklin and the bond trustee held a first mortgage on the properties and Franklin held a second mortgage on the properties. In addition, the developer arranged for an unrelated party to pledge to Franklin certain property, outside collateral, with a value of approximately 25 percent of the bond debt.

148. As of September 30, 1989, Franklin had outstanding 16 letters of credit on such projects.

149. Each of the properties at issue in Franklin's credit enhancement program has transferable tax exempt below market favorable financing, at approximately 200 basis points below the going rate for real estate financing. This favorable financing is made possible by the governmental entity that issued the bonds.

150. Several of the developers in this program, and the outside collateral providers, are in default to Franklin. Under the current situation, GAAP requires that Franklin treat such properties as already acquired through an "in substance foreclosure".

151. The issue involving the credit enhancement program concerns the classification of assets for the purpose of establishing loss reserves. OTS regulations require that valuation allowances be established pursuant to GAAP for classified assets. *See* 12 C.F.R. § 563.160 (d)(3). Under GAAP, in substance foreclosures are recorded at fair market value. The court finds that it has been established that the below market tax exempt bond financing on each of these properties is an economic at-

tribute that may be recognized in this valuation process under GAAP. Even defendant's own expert witness, William Trione, acknowledged that such favorable financing has some value. Thus, the court finds that the value of the tax exempt bond financing may be properly considered in the establishment of loss reserves.

152. After learning that OTS was questioning whether favorable financing had market value in determining the valuation allowance of the properties in Franklin's credit enhancement program, Franklin commissioned a set of investment value analyses which took into account the investment value attributable to the available favorable financing. These analyses indicated that such favorable financing had value in the market place.

153. Franklin has presented other evidence that indicates that this favorable financing has recognized value in the market. Mr. Schoeb testified that there has been a recent offer to purchase the Chesapeake Estates property at a price above the "cash equivalency" appraisal value. The cash equivalency appraisal value did not consider the value of the favorable financing. This offer of purchase was contingent on the assumability of the favorable bond financing. This offer of purchase above the value appraised without consideration of favorable financing indicates that such financing does have value in the market.

154. The court finds that there is recognized value in the market for the bond financing involved in the credit enhancement properties, and that 12 C.F.R. § 563.171 (b) (2) (i) (E) is not applicable to the facts presented. *See* Conclusion of Law No. 9. The court further finds that the value of such financing may properly be taken into account in determining the value allowances for those properties and establishing loss reserves. The OTS's attempt to establish a higher loss reserve based on its refusal to consider value for the available favorable financing is without reasonable basis and is based on an inappropriate application of a regulation.

F. *OTS's Write-downs Regarding Bond Defeasance.*

155. After the directed write-downs of $119 million for alleged inappropriate deferred hedging losses, and $46.9 million for inappropriate value allowances on the credit enhancement program, and $12.5 million for other valuation allowances and the exclusion of the Savers Life intangible, OTS directed an additional $185 million reduction in Franklin's capital to account for the bond defeasance of the $2.9 million zero coupon bond issuance made in 1984. *See, supra.*, Finding of Fact No. 22. OTS concluded that after the reductions were made for the other write-downs, Franklin would fail to meet its core and tangible capital requirements. OTS considered that this failure of capital requirements would likely trigger the bond defeasance/collateral substitution provision of the bond indenture. Bond defeasance or collateral substitution would result in a realization of $185 million reduction in Franklin's capital. Therefore, OTS ordered this additional write-down in capital.

156. The bond indenture provides that if Franklin files a report showing that it is out of capital compliance, the bond trustee is authorized to buy and substitute collateral that would have the effect of economically defeasing the bond. The bond indenture also provides for collateral substitution or legal defeasance if Franklin fails to file a required report for 25 days.

157. Prior to the February 16, 1990, appointment of conservatorship, Franklin never filed a report showing capital failure which would trigger defeasance of the bond indenture. Specifically, Franklin's 10Q for the period ended December 31, 1989, states that all the adjustments proposed by OTS would be resisted by "all appropriate means." Since OTS's directive concerning Franklin's method of hedge accounting and allowance for favorable financing in the credit enhancement program was wrong and clearly without reasonable basis, at the time of conservator imposition; any loss from collateral

substitution or legal defeasance on the zero coupon bonds was not an event likely to occur.

158. The court believes that the OTS improperly relied on the bond issue in reaction to its failure to act promptly with respect to similar zero coupon bonds issued by CenTrust Savings Bank of Miami, Florida. OTS wanted to avoid embarrassment, such as that caused by its failure to promptly act and to prevent a loss on the CenTrust bonds. Franklin, however, was not in the same position as CenTrust with regard to zero coupon bonds. Franklin had never reported capital failure as had CenTrust. OTS's attempt to draw a parallel between Franklin's case and CenTrust's case was improper. An OTS internal memo even indicates that the regulator knew that Franklin was not in the same situation as CenTrust. Exhibit 827 ("Well, it ain't CenTrust, but it's all we got."). OTS's action regarding the directed write-down for bond defeasance was arbitrary and capricious and without reasonable basis in law or fact.

G. *Safety and Soundness Grounds for Conservatorship.*

1. *Tax Agreements Between Franklin and Franklin Savings Corp.*

159. Franklin and its parent company, FSC, entered into tax reimbursement and tax forgiveness agreements. The tax forgiveness agreement began in 1985, at which time the Federal Home Loan Bank was fully informed and acquiesced to the agreements. The amount of this annual tax forgiveness is set forth in each year's audited accounting statements for Franklin and the federal regulators have been fully apprised of the content of these agreements each year from 1985 through the present.

160. Similar tax agreements have been entered into by at least one other thrift in the OTS/Topeka district with the approval of the regulator at the time it was initially executed.

161. Throughout the time that the tax agreements between Franklin and FSC have been in force, Franklin's excess regulatory captial has exceeded the cumulative amount of tax forgiveness. Franklin maintained the tax forgiveness agreements as part of capital only to provide a capital cushion and not for the purpose of leveraging the institution or to increase its growth.

162. At the time the conservatorship was imposed, no taxes were due or owing by FSC or Franklin under the tax agreements.

163. At all times, FSC has had the means available to pay any tax which would become due under the tax forgiveness and tax reimbursement agreements.

164. Franklin has accounted for the tax agreements in accordance with GAAP.

165. In the event any tax is ever owing, the tax can be paid by the holding company either through borrowing money, selling stock, or by liquidating Franklin. Under no situation would the tax be paid by having Franklin pay a dividend to FSC. The operation of the tax agreements between Franklin and FSC are wholly unlike the operation of the tax agreements in the *Lincoln Savings* case. The tax agreements in the *Lincoln Savings* case were clever devices used for upstreaming funds from the savings association to the parent company. *See Lincoln Savings,* Nos. 89-1318 and 89-1323, *supra.*, at 17-19.

166. On January 9, 1990, OTS informed Franklin of the regulator's concern about the tax agreements and that it would seek a write-down of $110.4 million to reflect the value of the tax agreements included in Franklin's capital. After correspondence was exchanged between Franklin and OTS, OTS decided to hold the tax agreements issue in abeyance pending further consideration.

167. The tax agreements were not a basis for the initial conservatorship decision, but instead were raised

only as part of the second wave of adjustments ordered on March 9, 1990. In the March 9, 1990, directive, OTS stated that Franklin's handling of the tax agreements was an unsafe and unsound practice and ordered a $110.4 million write-down in capital.

168. OTS has no written policy governing the tax agreements at issue in this case. The court finds that the OTS acted arbitrarily and capriciously and without reasonable basis in seeking to create a written policy regarding tax agreements, after the fact, when no such policy existed. *See* Exhibit 393. This court finds that plaintiffs have shown that the tax agreements in this case raise no issue of safety or soundness and provide no reasonable basis to support the imposition of a conservator.

2. *OTS's Concerns Over Franklin's Innovative Methods of Operation.*

i. Franklin's Reliance on Brokered Deposits.

169. Over the past five years, Franklin's reliance on brokered deposits has increased significantly. As of December 31, 1989, Franklin had $3,290,981,000. in brokered deposits which represented 70.7 percent of its total deposits and 37.2 percent of its total liabilities. The regulator found that brokered deposits represented a high cost of funds and that Franklin's reliance on brokered deposits placed the institution in an unsafe and unsound condition.

170. The court finds Mr. Fleischer's testimony regarding Franklin's brokered deposits transactions to be highly credible and persuasive.

171. Franklin has submitted monthly brokered deposit reports to the Federal Home Loan Bank and to OTS since June 1984. Franklin has kept OTS fully apprised of its brokered deposit transactions.

172. From June 30, 1988, through February 12, 1990, Franklin's cost for brokered deposits declined from 124

basis points over the U.S. treasury yield curve to 82 points over the yield curve.

173. During the second half of 1989, Franklin determined that it could reduce its funding cost for brokered deposits by taking steps to level out the amount of brokered deposits that would be maturing each week. To accomplish this goal, Franklin increased the amount of brokered deposits in November and December of 1989. This increase was to enable Franklin to reduce its cost of brokered deposits beginning January 1, 1990. By leveling the amount of brokered deposits maturing each week, Franklin was able to set an interest rate significantly under the market and consistently obtain brokered deposits at that below market rate.

174. In determining its cost of funds, Franklin considers the costs associated with servicing depositors' accounts in addition to the interest being paid to depositors. In determining its "all-in- cost" for brokered deposits, Franklin computes the interest rate paid to the depositors, the fee paid to the brokerage firm, the insurance costs and the FDIC fee, and the associated overhead cost. To fairly compare the cost of funds between institutions, all associated costs must be considered, such as the cost of processing checks or to operate a branch facility. By analyzing costs on an all-in basis, Franklin's brokered deposits are shown to not constitute an unusually high cost of funds, but actually are shown to represent a relatively low cost of funds.

175. This court finds that OTS has failed to consider all relevant information in analyzing Franklin's use of brokered deposits. Further, the court finds that OTS's conclusion that such funds as used by Franklin were a high cost of funds is without reasonable basis. The court finds that Franklin's liability portfolio of brokered deposits presented no safety or soundness issue at the time the conservatorship was imposed.

ii. Cost of Funds.

176. The OTS determined that Franklin's cost of funds was consistently higher than both the average cost of funds for Kansas thrift associations and for all thrifts throughout the nation. According to OTS calculations, Franklin's cost of funds as of December 31, 1989, was 10.42 percent whereas the average cost for Kansas thrifts was 8.37 percent and the national average for thrifts was 8.3 percent. The regulator found that Franklin's reliance on higher cost of funds caused it to invest in higher yielding and riskier assets, and thus, created an unsafe and unsound condition of operation.

177. OTS's comparison of Franklin's cost of funds and the cost of funds of other institutions is misleading. First, OTS does not compare the all-in-cost of funds among the institutions. OTS does not take into account the institutions' cost of operating branch facilities and other such costs involved in acquiring deposits. Secondly, OTS compared Franklin, which hedges its funding cost, with other institutions which did not hedge. Therefore, Franklin's cost of funds includes hedging costs, whereas the cost of funds figures for the other institutions do not include such hedging costs. Thus, the sharp drop in interest rates occurring in the quarter ended June 30, 1989 (150 basis points), caused Franklin to defer hedging losses of approximately $240 million during that period. These deferred hedging losses are reflected in Franklin's cost of funds, but not in the cost of funds of the comparison institutions which do not hedge. This comparison of cost of funds by OTS omits the repricing gains which will result from the declining cost of liabilities when those liabilities reprice in the future, and thus, is inherently misleading.

178. Franklin has shown that its historical cost of funds is not relevant to any investment decision made by Franklin. Therefore, OTS is incorrect in concluding that Franklin's cost of funds results in investments in riskier

assets. In making its investment decisions, Franklin looks at what it would cost Franklin to fund a particular asset in question, not the historical cost of funds. Franklin's investments at all times were governed by the determination of the option adjusted spread remaining between the interest income on assets and the cost associated in acquiring and carrying those assets, taking into account all risks associated with the asset. Thus, Franklin's cost of funds had nothing to do with the investments being acquired, other than to establish a base or floor return which would have to be achieved after giving full recognition to all costs.

179. This court finds that the OTS's comparison of cost of funds between Franklin and other institutions was performed in a manner which fails to consider relevant facts, and thus, is inherently misleading. Plaintiffs have shown that Franklin's cost of funds did not present a safety or soundness concern at the time of the imposition of the conservator.

iii. TB 12 Assets.

180. Since 1986, Franklin has increased the amount of assets in its portfolio of the type described in *Thrift Bulletin No. 12* (TB 12 assets), such as principal-only strips ("POs"), interest-only strips ("IOs"), collateralized mortgage obligation residuals ("CMOs"), and support traunches of planned amortization classes of CMOs. Franklin's mortgage backed security ("MBS") portfolio increased from $388 million as of June 30, 1983, to $1.1 billion as of December 31, 1984. By June 30, 1989, Franklin had acquired $187 million in high yield bonds and $3.6 billion in mortgage derivative products, which represented 35 percent of Franklin's total assets.

181. OTS criticized the amount of Franklin's TB 12 assets. OTS found that Franklin's increased concentration in these securities presented safety and soundness concerns. Also, OTS felt that after its directed adjust-

ments for credit enhancement and deferred hedging losses were made, the institution was materially under-capitalized to possess TB 12 assets.

182. TB 12 assets are extremely sensitive to changes in interest rates and prepayment rates and also have a significant prepayment risk. To accurately value TB 12 assets, Franklin must accurately predict prepayment rates and otherwise model the performance of these assets. The failure to accurately do so could result in these assets being significantly over or under valued.

183. Franklin has demonstrated that through the efforts of its management and the use of computer modeling, the sensitivity of its TB 12 assets portfolio to both interest rate risk and prepayment risk had declined from June 30, 1988, through October 31, 1989, and was anticipated to continue declining through June 30, 1990.

184. As a result of this declining interest rate and prepayment sensitivity, Franklin's TB 12 asset portfolio had approximately the same sensitivity as the 9.5 percent GNMA mortgage back[ed] security.

185. The OTS was also concerned with the liquidity of TB 12 assets. Franklin has clearly demonstrated that a market exists for TB 12 assets. In fact, Franklin acquired all of its TB 12 assets in market transactions from firms which are primarily dealers in such assets.

186. OTS's criticism about the level of TB 12 assets held by Franklin is inappropriate. Pursuant to OTS direction, Franklin has been shrinking its amount of TB 12 assets since November 1, 1989, and has completed a net shrinkage of $605 million in its TB 12 portfolio.

187. The court finds that Franklin was properly monitoring and managing its TB 12 assets portfolio. The court finds that Franklin's possession of and the amount of TB 12 assets in its portfolio did not raise legitimate safety or soundness concerns. The OTS's conclusions to the contrary are without reasonable basis.

iv. Computer Models.

188. Franklin's computer models, including its prepayment model in use at the time of the conservatorship (FSA-3), have been accurately described as "state of the art or very close to it." (Administrative Record, Document No. 34 or Exhibit 272 (McConnell Report) and testimony of Walter Torous). In particular, FSA-3 is a very good indicator of prepayment risk and is a significant improvement over FSA-1, the earlier prepayment model which also had been considered as state of the art. Furthermore, the option adjusted spread models used by Franklin are sophisticated management tools.

189. This court has considered and reviewed carefully the expert testimony provided by the parties concerning Franklin's computer models. The court finds that the testimony of Dr. Walter Torous is highly credible and persuasive. Dr. Torous, professor of finance at the UCLA School of Business, has extensively studied Franklin's models, including both the FSA-1 and the FSA-3 models, and has found that those models provide an accurate indicator of prepayment risk.

190. Franklin's models were used as tools in investment and hedging decisions and in estimating the institution's net equity value. Franklin's management used the information provided by models to assist them in making judgment decisions.

191. From the evidence presented to this court, the court has no difficulty finding that Franklin had assembled an exceptionally able and experienced staff to develop its computer models and to interpret and appropriately apply the information generated by those models.

192. The court finds that Franklin's use of sophisticated and complex computer models do not raise significant safety and soundness concerns which would justify the regulator's action.

3. *Other Safety and Soundness Issues.*

193. The safety and soundness issues regarding Franklin's deferred hedging losses and sales of assets has already been discussed in previous findings of fact, *see, supra*., Findings of Fact Nos. 132-144.

194. OTS has at various times suggested other "safety and soundness" concerns. The court finds that these other raised concerns are not supported in the record, and therefore, provide no basis for the appointment of conservator.

195. Since 1984, Franklin has never sought to use all its regulatory capital. For the fiscal year ended June 30, 1985, through the fiscal year ended June 30, 1989, Franklin's use of regulatory capital ranged from 35 percent to 65 percent. The average usage of regulatory capital for all those years is approximately 54 percent.

196. Franklin's distribution of dividends raises no issues of safety and soundness. OTS and FHLBB have either approved or raised no objections to any dividend distribution made by Franklin during the past five years. (Pretrial Order stipulation (ay)).

197. Franklin's portfolio of high yield, or "junk," bonds presents no issue of safety and soundness. As of June 30, 1989, Franklin's portfolio contained approximately $187 million in high yield bonds, roughly 2 percent of its assets. Franklin's board had decided to dispose of all these assets on or by June 30, 1990, well before the 1994 disposition date required in FIRREA.

198. In this case, the safety and soundness issues raised by OTS are unconvincing since Franklin had GAAP capital of $387 million on December 31, 1989, and an economic value of not less than that amount. Also, since June 30, 1988, through the time of the imposition of the conservator, Franklin had shown increases in capital, both measured under a GAAP basis and by analyzing the

institution's economic value. GAAP capital had been increasing by an average of $55 million per year.

199. For the fiscal years ended June 30, 1988, and June 30, 1989, Franklin had over $90 million of net interest income. From June 30, 1986, through June 30, 1989, net interest income represented an increasing share of the total income reported by Franklin.

200. Franklin's net interest margin has deteriorated over the last five years from 2.01 percent for the year ended June 30, 1985, to .95 percent for the year ended June 30, 1989. Once adjustments are made so that the net interest margin accurately reflects the economic situation of Franklin, however, the evidence shows that Franklin achieved the 100 basis point (1 percent) net interest margin that it had targeted over the past five years. The net interest margin equals the net interest income for a period divided by total assets. To determine the adjusted net interest margin for Franklin, it is necessary to consider two factors. First, the assets represented by Franklin's collateralized mortgage obligation ("CMO"), should be deconsolidated, so that the assets which Franklin has pledged to owners of traunches within the CMO are removed from the calculation of net interest margin. Secondly, the estimated cost of operating Franklin's branches should be deducted from Franklin's net interest income. After considering these adjustments, the court finds that Franklin has achieved its 100 basis point net interest margin over the past five years.

201. The lower net interest margin reported by Franklin as of December 31, 1989, resulted from GAAP accounting anomalies and was not indicative of the economic health of Franklin. The net interest income had been squeezed during the accounting period ended December 31, 1989, by the amortization of deferred hedging losses in advance of the recognition of gains from liability repricings which offset those hedging losses. The anomaly

had a particularly significant effect during the quarter ended June 30, 1989, when interest rates dropped by 150 basis points, causing significant futures losses up to year in advance of the liability repricing gains which would offset those losses. Also, the decline in net interest margin for the period ended December 31, 1989, also was affected by the flattening of the treasury yield curve during that period.

202. The court finds the testimony of Dr. Samuel Stewart to be reliable concerning the economic value of Franklin as a going concern. Dr. Stewart has a PhD from Stanford in finance and has taught at Columbia University and the University of Utah. Dr. Stewart is president of Wasatch, Inc., an investment firm. Dr. Stewart has had extensive experience in valuing savings and loan institutions and in counseling investments in such institutions on his evaluations.

203. The court accepts as reliable Dr. Stewart's estimate of the going concern value of Franklin as of February 15, 1990, to equal between $250-700 million.

204. During the examination of Franklin, OTS had retained Dr. John McConnell, a professor at Purdue University, Lafayette, Indiana, to examine Franklin's modeling technology and to determine Franklin's economic value. Dr. McConnell concluded that Franklin's economic net worth would have a liquidation/replacement value of approximately $129.7 million as of September 30, 1989. The court does not find that the liquidation/replacement value is relevant or meaningful when considering the economic value of a going concern such as Franklin, which has economic capital and liquidity reserves. Moreover, Dr. McConnell's testimony during cross-examination created questions about the accuracy of his figures.

205. Dr. Darrell Duffie, professor of finance at Stanford University, was called as a witness by the OTS to testify about the types of risk facing Franklin's opera-

tions, his reservations with Franklin's computer models, and the changes in Franklin's net equity value.[11] Dr. Duffie's testimony consisted of theoretical evaluations of the risks presented to Franklin's operation and other thrifts in general. Moreover, Dr. Duffie's testimony was largely an attempt by OTS to provide some post hoc justification for the regulator's action. The court finds that Dr. Duffie's testimony is of little help in this case and grants it little weight regarding the practical reality of Franklin's economic condition and operations and the necessity for appointing a conservator.

206. The testimony of Dr. Stewart and the other evidence presented by Franklin, including the fact that Franklin had a GAAP capital of $387 million as of December 31, 1989, provides clear proof that Franklin was not insolvent or in a weakened condition at the time the conservator was imposed and that Franklin presented no risk to the Savings Association Insurance Fund (SAIF).

207. From the year ended June 30, 1985, through the year ended June 30, 1989, Frankling showed positive income when measured under GAAP, economic, and normalized conventions. For the year ended June 30, 1989,

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[11] The court is aware that a motion to strike Exhibit No. 2813 is still pending. The court took this motion under advisement during Dr. Duffie's testimony on July 17, 1990. Plaintiff moved that this exhibit be stricken from the record since Duffie could not provide the records or reports for the numbers used in that exhibit. The court granted defendant 48 hours to show the foundation for that document and defendant made such a submission on July 19, 1990 (Doc. 361). The court has received and has considered the letter memorandum of plaintiff responding to this submission and defendant's reply thereto (Docs. 383 and 384). The court finds that the motion to strike should be denied. The court will allow Exhibit 2813 to remain in the record. The court is fully aware of the errors in the numbers used by Dr. Duffie as pointed out in plaintiff's letter response (Doc. 383) and has considered the corrected accurate numbers in consideration of this exhibit and of Dr. Duffie's testimony.

Franklin showed GAAP earnings of $43 million, economic earnings of $78 million and normalized earnings of $99 million.

208. Given the fact that the hedge accounting, credit enhancement, tax agreement and bond defeasance issues are ultimately resolved in Franklin's favor, the court finds that is clear that the safety and soundness issues raised by OTS provide no basis for the imposition of a conservatorship.

H. *Charges of Biased or Prejudiced Action by OTS.*

209. Franklin has contended that OTS acted with improper bias and prejudice and in bad faith against Franklin. Although the court has found that the OTS lacked statutory grounds for the imposition of conservator and that the regulator made erroneous findings and conclusions which lacked any reasonable basis, the court finds that the regulator's actions cannot be characterized as biased or prejudiced against Franklin or taken in bad faith. It is most likely that OTS/Topeka was motivated by the disturbing events that had occurred earlier with regard to Silverado Savings and Loan in Colorado and its difficulty with Franklin's unique and innovative operations. Nevertheless, the court finds that Franklin has not shown that OTS was motivated in its decisions regarding the 1989 examination and the ultimate imposition of the conservator in February 1990 by bias or prejudice against Franklin or out of any type of bad faith.

III. CONCLUSIONS OF LAW

A. *General Conclusions.*

1. The court incorporates the legal conclusions made earlier in this Memorandum and Order regarding the proper role of the court in reviewing the regulator's actions. *See, supra.*, pp. 2-13.

2. Any finding of fact herein which should have been deemed a conclusion of law is hereby adopted as such,

and any conclusion of law which should have deemed a finding of fact is hereby adopted as such.

B. *Statutory Grounds for the Appointment of a Conservator.*

3. Section 301 of FIRREA (to be codified at 12 U.S.C. § 1464(d)(2)(C) grants the director of the Office of Thrift Supervision the power to appoint a conservator or receiver of a state chartered federally insured savings association if, in the opinion of the director, any of the grounds specified in 12 U.S.C. § 1464(d)(2)(C)(i) through (vi) exist with respect to the savings association.

4. The director may appoint a conservator or receiver with the written approval of the state official having jurisdiction over the state savings association if one or more of the grounds specified for such appointment exist. 12 U.S.C. § 1464(d)(2)(D)(i).

5. Director Wall determined that three of the six statutory grounds for appointing a conservator existed with respect to Franklin Savings. The director found that:

> (1) the association was in an unsafe and unsound condition to transact business, including having substantially insufficient capital or otherwise, 12 U.S.C. § 1464(d)(2)(C)(iii);
>
> (2) the savings association had incurred or was likely to incur losses that would deplete all or substantially all of its capital and there was no reasonable prospect for the association's capital to be replenished without federal assistance, 12 U.S.C. § 1464(d)(2)(C)(v); and
>
> (3) there was a violation or violations of laws or regulations, or an unsafe and unsound practice or condition which was likely to cause insolvency or substantial dissipation of assets and earnings, or was

likely to weaken the condition of the association, 12 U.S.C. § 1464(d)(2)(C)(vi).

6. In an action seeking the removal of a conservator, this court "shall upon the merits dismiss such action or direct the director to remove such conservator." 12 U.S.C. § 1464(d)(2)(E). In reviewing whether the statutory grounds existed for OTS to appoint a conservator, the sole question before the court is whether the director reasonably determined that a statutory ground existed at the time the institution passed into conservatorship. *Biscayne Federal Savings & Loan Assn. v. FHLBB*, 720 F.2d 1499, 1504 (11th Cir. 1983), *cert. denied* 467 U.S. 1215 (1984)); *see also Woods v. FHLBB*, 826 F.2d 1400, 1407 (5th Cir. 1987), *cert. denied* 485 U.S. 959 (1988)).

7. FIRREA and OTS regulations require savings and loan associations, including Franklin, to account for gains or losses on financial futures contracts, designated as hedges, in accordance with generally accepted accounting principles. Section 301 of FIRREA, 103 Stat. 280 (to be codified at 12 U.S.C. § 1463(b)(1), (2)); 12 C.F.R. § 563.233 (OTS regulation mandating compliance with GAAP). An accounting procedure which accords with a pronouncement of the Financial Accounting Standards Board, such as FAS 80, is by definition a generally accepted accounting principle.

8. The Supreme Court has noted:

> Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will insure transactions. "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments leaving the choice among alternatives to management.

Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 544 (1979).

9. OTS argues that its conclusion not to consider the value of favorable financing is required by applicable fed-

eral regulations, *citing* 12 C.F.R. § 563.172(a) and 12 C.F.R. § 563.171(b)(2). These regulations require that real estate, at the time of in substance foreclosure or actual acquisition, must be appraised at its fair market value. 12 C.F.R. § 563.171(b)(2)(i). The regulation further requires that the "price for the property represent normal consideration for the property sold unaffected by special or creative financing granted by anyone associated with this sale." 12 C.F.R. § 563.171(b)(2)(E). The court finds that this provision of the regulation is inapplicable to Franklin's credit enhancement program. In the credit enhancement properties, the favorable financing is made possible by the bond issuer who makes loans to the developer at a lower than market rate of interest. Therefore, the favorable financing involved in the credit enhancement programs is not provided by "anyone associated with the sale."

10. 12 C.F.R. § 567.5(a)(2)(ii) sets forth an exception to the general rule that intangible assets may not be included as part of a savings association's capital. Such assets may be included in determining core capital if (1) the asset is separate and sold apart from the savings association; (2) the asset has an established market value based on an identifiable stream of cash flows which will not be affected by the future prospects of the savings association; and (3) a market exist which will provide liquidity for the asset. 12 C.F.R. § 567.5(a)(2)(ii). Based on the established facts, the block of Sun Life policies purchased by Franklin's subsidiary are includable assets in Franklin's capital.

11. Generally, a savings association's investment in or extension of credit to any subsidiary engaged in activities not permissible for a national bank shall be deducted from the association's capital. Section 301 FIRREA, 103 Stat. 305-306 (to be codified at 12 U.S.C. § 1464(t)(5)(A)). However, such investments may be included in capital if the association's subsidiary was involved in the activity

before April 12, 1989. The association may include in calculating capital an amount up to the amount of the association's investments in or extension of credit to the subsidiary as of April 12, 1989. FIRREA, 103 Stat. 306 (to be codified at 12 U.S.C. § 1461(t)(5)(D)). Based on the facts established, Franklin could properly include in its capital calculation the amount of its investment in the Savers Life subsidiary.

12. Issues of safety and soundness must be viewed in the context of the institution as a whole. *Gulf Federal Savings & Loan Assn. v. Federal Home Loan Bank Board*, 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied* 458 U.S. 1121 (1982)). "The breadth of the unsafe or unsound practice formula is restricted by its limitation to practices with a reasonably direct effect on an institution's financial soundness." *Id.*

13. Based on all the findings of fact established above, it is this court's conclusion of law that the OTS acted inappropriately in placing Franklin in conservatorship, and that the OTS lacked any factual basis which would justify its appointment of a conservator under the three statutory grounds relied on by the regulator. This court further concludes that the OTS acted arbitrarily and capriciously in appointing the conservator. Accordingly, the court will order the director of OTS to remove the conservator and return control of Franklin to its former board of directors and management.

C. *Whether the Appointment of the RTC as Conservator for Franklin Creates an Incurable Conflict of Interest.*

14. In Count VI of their complaint, plaintiffs contend that the RTC should be removed as conservator because it has an incurable conflict of interests which prevents it from being able to fulfill it fiduciary and conservatorship obligation to Franklin and its stockholders. This allega-

tion is based principally on the fact that at the time of its appointment, RTC was already serving as a conservator for Victoria Savings Association. At the time of the appointment, Franklin was prosecuting a lawsuit on a claim of $36 million against Victoria Savings. Since the court has found and concluded that the OTS had no statutory ground for appointing a conservator for Franklin, and will order the removal of the conservatorship, the court finds it unnecessary to address this now moot issue.

D. *Constitutional Claims.*

15. In Count VIII of their complaint, plaintiffs contend that the actions of the OTS violated their constitutional rights of due process, since they were not afforded a hearing prior to the seizure of the institution. The provisions of 12 U.S.C. § 1464(d)(2)(E) provide plaintiffs with an opportunity for post-conservationship hearing. The fact that judicial review is available only after the deprivation of property has occurred does not render that available review constitutionally inadequate. *See Haralson v. FHLBB*, 837 F.2d 1123, 1126 (D.C. Cir. 1988). As the Supreme Court has commented, regulations that provide for a hearing after a conservator takes possession of an institution is a drastic procedure. *Fahey v. Mallonee*, 332 U.S. 245, 253 (1947). However, given the nature of the savings and loan industry and the significant governmental interest in the regulation of federally insured savings and loan associations, the requirements of constitutional due process are accomplished by the provision allowing for a hearing after the government's drastic action. *See id.;* and *Haralson*, 837 F.2d at 1126-27. Accordingly, the court concludes that there is no violation of plaintiffs' constitutional right of due process by the regulatory scheme provided and set out in FIRREA, given the fact that plaintiffs have been provided a full and meaningful opportunity to present their case and to challenge the government's action after the appointment of the conservatorship.

16. In Count VII of their complaint, plaintiffs argue that the appointment of the conservator was an unconstitutional taking in violation of the Fifth and Fourteenth Amendments of the Constitution. The relief that plaintiffs seek on this claim is the removal of the conservator. Since the court, for other reasons, will grant the relief that plaintiffs seek on this claim, the court finds that it is unnecessary to address plaintiffs' constitutional taking claim.

E. *Improper or Retroactive Rule Making.*

17. OTS has stated that accounting statements prepared by savings associations "shall be prepared on the basis of generally accepted accounting principles." 54 Fed. Reg. 49,595 (Nov. 30, 1989); *see also* 54 Fed. Reg. 49,683, 49,684, 49,685 (Nov. 30, 1989); and 54 Fed. Reg. 49,627, 49,628 (Nov. 30, 1989).

18. Any OTS determination specifying accounting requirements more stringent than GAAP must be uniform and must be promulgated by regulation under the APA. FIRREA, 103 Stat. 280 (to be codified at 12 U.S.C. § 1463(B)(1), (3)). In Counts III and IV of their complaint, plaintiffs argue that the OTS improperly required compliance with standards more stringent than GAAP without going through the appropriate rule making process required by the APA and retroactively applied these more stringent rules. The court concludes that OTS was not attempting to retroactively apply new, more stringent standards in reviewing Franklin's hedge accounting policies and tax agreements. Simply, OTS was advocating an erroneous interpretation of GAAP and wrongly holding that Franklin's practices were not GAAP, and consequently in effect, OTS required accounting methods more stringent than GAAP. This was not a case of improper or retroactive rule making, but one of erroneous application of existing regulatory rules.

V. FINAL COMMENT.

The court's concern and review in this case is limited to whether the OTS acted properly in February 1990 in appointing a conservator for Franklin. The court realizes that Franklin is not the same institution today that it was as of February 16, 1990, after six months of control by RTC. There could very well be some difficulty in Franklin's management reacquiring control and operating Franklin today. That, however, is not the court's concern. The court was asked to determine whether the regulator's action was valid and appropriate at the time it was taken. We have performed this task in an expeditious and judicious manner.

The facts of this case clearly show that the regulator acted wrongly in imposing the conservatorship. This court must correct that wrongful action. Any problems in the reacquisition of control by Franklin's management is a direct result of the OTS's wrongful conduct in February 1990.

It will now be the responsibility of Franklin's management, and not the court, to effectively develop a plan for operating the association after six months of conservatorship, during which they had no control.

Finally, the court, in its order, will retain jurisdiction for a period of 90 days, during which the OTS cannot attempt to impose a conservator or receiver for Franklin without first obtaining leave of this court to do so. Although the court retains jurisdiction for this limited purpose, this decision is an appealable final judgment and the time for appeal is not affected by the court retaining jurisdiction for the limited purpose set out herein.

IT IS THEREFORE BY THE COURT ORDERED that since no statutory ground for the imposition of a conservatorship existed and since the OTS's action in imposing the RTC as conservator lacked any basis in fact and was arbitrary and capricious, the director of OTS is

hereby ordered to remove the conservator now in place and to return control of Franklin Savings Association to its pre-conservatorship directors and management at 10 a.m. CDT, Thursday, September 6, 1990.

IT IS FURTHER ORDERED that both parties and the RTC cooperate fully to facilitate an orderly transfer of control of the institution.

IT IS FURTHER ORDERED that plaintiffs' motion to strike Exhibit 2813 is denied.

IT IS FURTHER ORDERED that plaintiffs' second motion for summary judgment (Doc. 183) is rendered moot by the above memorandum and it is therefore denied.

IT IS FURTHER ORDERED that defendant's motion for summary judgment on Counts I and II and for judgment on the pleadings on Counts VI, VII and VIII, and for summary judgment for lack of capacity (Doc. 174) has been rendered moot by the above memorandum and is therefore denied.

IT IS FURTHER ORDERED that the court will retain limited jurisdiction in this case for a period of 90 days, during which period the OTS cannot attempt to place Franklin into another conservatorship or a receivership without first obtaining leave of this court to do so.

IT IS FURTHER ORDERED that the court's retention of jurisdiction for this limited purpose does not affect the parties rights to pursue an appeal or affect the time for filing notice of appeal from this final judgment.

IT IS FURTHER ORDERED that the Clerk of the Court enter judgment in this case for the plaintiffs.

Dated this 5th day of September, 1990, at Topeka, Kansas.

/s/ Dale E. Saffels
DALE E. SAFFELS
United States District Judge

APPENDIX D

OFFICE OF THRIFT SUPERVISION

Appointment of Conservator
Franklin Savings Association
Ottowa, Kansas

Order No. 90-368
Date: February 15, 1990

RECITALS

A. Franklin Savings Association, Ottowa, Kansas ("Association") is a stock savings association chartered under the laws of the State of Kansas, the accounts of which are insured by the Federal Deposit Insurance Corporation.

B. Pursuant to § 5(d)(2)(C) of the Home Owners' Loan Act of 1933 ("HOLA"), as amended by § 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), the Director of the Office of Thrift Supervision ("Director") shall have power and jurisdiction to appoint a conservator for an insured state savings association if one of the grounds set forth in § 5(d)(2)(C)(i) through (vi) of the HOLA, as amended, exists.

C. Pursuant to § 5(d)(2)(H)(ii) of the HOLA, as amended, the Director, at the Director's discretion, may appoint the Federal Deposit Insurance Corporation or the Resolution Trust Corporation ("RTC"), as appropriate, as conservator for a savings association.

ORDER

1. The Director, upon consideration of the administrative record and for the rationale set forth in the Legal Memorandum dated February 14, 1990 and the Executive

Summary dated February 14, 1990, hereby finds and determines that: the Association is in an unsafe and unsound condition to transact business in that, among other things, the Association has a significant level of high risk assets, and has placed undue reliance on brokered deposits, (b) the Association has incurred and is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the Association's capital to be replenished without Federal assistance, and (c) there is a violation or violations of laws or regulations, or an unsafe or unsound practice or condition which is likely to cause insolvency or substantial dissipation of assets or earnings, or is likely to weaken the condition of the Association or otherwise seriously prejudice the interests of its depositors; and the Director hereby finds and determines that grounds for the appointment of a conservator for the Association therefore exist under § 5(d)(2)(C)(iii), (v), and (vi) of the HOLA, as amended.

2. The Director, upon consideration of the administrative record, further hereby finds and determines that the Association has suffered a pattern of consistent losses, and there is an unsafe and unsound condition or activity other than a failure to meet capital standards.

3. The Director hereby appoints the Resolution Trust Corporation as conservator for the Association, not for the purpose of liquidation, pursuant to subdivisions (C), (E), and (H)(ii) of § 5(d)(2) of HOLA, as amended, and § 11(c)(6)(B) of the Federal Deposit Insurance Act, as amended, *provided*, however, that this appointment shall not be effective unless and until the provisions of subdivision (D)(i) of § 5(d)(2) of HOLA, as amended, have been complied with.

/s/ M. Danny Wall
M. DANNY WALL
Director

No. 91-1139

Supreme Court, U.S.
FILED
FEB 10 1992
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Petitioners.

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION
and UNITED STATES OF AMERICA,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF AS AMICI CURIAE OF THE AMERICAN BANKERS ASSOCIATION, THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA AND NATIONAL COUNCIL OF COMMUNITY BANKERS IN SUPPORT OF PETITIONERS

LEONARD J. RUBIN
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QUESTION PRESENTED

Whether the court of appeals erred in holding that the scope of review under 12 U.S.C. section 1464(d)(2)(E), which provides for an "action" in district court to determine "upon the merits" the legality of a government seizure of a savings and loan institution, can be limited consistent with the commands of the statute and the Due Process Clause to documents designated for the record by the government, thereby precluding the district court from considering:

a) any evidence submitted by the savings and loan's representatives, even though there was no prior opportunity to submit evidence concerning the grounds for the seizure because it was *ex parte* and without notice or prior proceeding; or

b) the whole administrative record in existence at the time of the seizure.

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MISCELLANEOUS:

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1139

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Petitioners,

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION
and UNITED STATES OF AMERICA,
Respondents.

BRIEF AS AMICI CURIAE OF THE AMERICAN BANKERS ASSOCIATION, INDEPENDENT BANKERS ASSOCIATION OF AMERICA AND NATIONAL COUNCIL OF COMMUNITY BANKERS IN SUPPORT OF THE PETITIONERS

INTEREST OF THE AMICI CURIAE

The American Bankers Association, Independent Bankers Association of America and National Council of Community Bankers hereby respectfully submit this brief as amici curiae in support of the Petitioners with the consent of the parties. The signed consents of each are filed together with this brief.

The American Bankers Association and Independent Bankers Association are national trade associations of the commercial banking industry in the United

States. Together, they represent all but a handful of the commercial banks in the country. The National Council of Community Bankers represents approximately 350 savings institutions, some of which are directly affected by the decision in the Franklin case.

This litigation involves an interpretation and application of Section 5(d)(2)(E) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which is directed at savings associations (such as the Petitioners in this case) represented by the amicus NCCB. There is a corresponding provision of the 1989 Act, 103 Stat. at 222-24 (12 U.S.C. § 1821) directed at the commercial banks represented by the amici, ABA and IBAA. Interpretations of one of these two provisions may constitute precedent for interpretation of the other. Both statutes provide for the appointment by a federal agency of a federal agency as conservator for insured financial institutions under certain specified statutory conditions. By its very nature, a conservatorship ousts the ownership and management of the institution in question. To date, it has not been a frequently used tool with respect to the banking industry, but promises to become more so. Recent news stories surrounding the operation of CrossLand Federal Savings Bank by the Federal Deposit Insurance Corporation suggest that it is "the beginning of a new FDIC strategy for tackling problem thrifts."[1] The Chairman of the FDIC is quoted as saying that the government operation of CrossLand, rather than its liquidation, "is the least costly

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[1] N. Barsky & K. Bacon, *FDIC Rejects Two Bids for CrossLand, Puts Up $1.2 Billion of Its Own Capital,* Wall St. J., Jan. 27, 1992, at A5.

alternative to us." *Id.* FDIC is required by law to use the least costly alternative in resolving failed or failing institutions. 12 U.S.C. § 1823(c)(4)(A).

While they are heavily regulated both by federal and state authorities, commercial banks and savings institutions remain privately owned and operated businesses, just as surely as any restaurant or gas station. As private businesses, financial institutions, their managements and their owners have liberty and property interests at stake that are as deserving of constitutional protection against unchecked government action as would be the interests of any other citizens. In this case, where a federal agency is given, without exaggeration, life-and-death authority over private business, constitutional scrutiny should be at its highest. *Brock v. Roadway Express, Inc.*, 481 U.S. 252, 261 (1987). But the Tenth Circuit here has gone to the opposite extreme, leaving the business entirely to the discretion of the regulatory agency, pursuing its own agenda, and with no meaningful recourse. Member institutions of the three sponsoring trade associations have a distinct interest in protecting their own due process rights for the future.

SUMMARY OF THE ARGUMENT

The Respondent, Director of the Office of Thift Supervision, appointed a conservator for the Petitioner, Franklin Savings Association. That is an action subject to judicial review "on the merits," and such a review was sought by Franklin. The Tenth Circuit concluded that an "on the merits" review of the appointment was a review limited to such portions of an "administrative record" as the Director chose to present to the District Court. That decision is in-

consistent with the plain language of the statute; it effectively deprives the aggrieved institution of any kind of meaningful hearing, either predeprivation or postdeprivation of its property rights in violation of the due process clause of the Fifth Amendment; and it effectively sanctions a process which, in like circumstances, has been found unconstitutional in recent months by a sister Circuit. For those reasons, this Court should grant the Petition for Writ of Certiorari.

REASONS FOR GRANTING THE WRIT

It is important that this Court grant the Petition for Writ of Certiorari in order assure compliance by the lower courts with binding precedents of this Court and to reconcile the competing views of the Due Process Clause (and this Court's consistent interpretation of it) of the Tenth Circuit in this case and the First Circuit in its recent *Reardon v. United States* decision.

The Plain Language of the Statute

We begin the analysis by pointing out that the plain language of a statute is normally controlling. *See, e.g., Board of Governors of the Federal Reserve System v. Dimension Financial Corporation*, 474 U.S. 361, 373-74 (1986). In this case, the applicable statute, 12 U.S.C. § 1464(d)(2)(E), entitles a savings association placed in conservatorship to judicial review of that action "on the merits." That term has a reasonably well understood plain meaning, developed in a variety of contexts. For example, a number of Supreme Court cases have concluded that the doctrine of res judicata generally is applicable when there has been an adjudication "on the merits," but not otherwise. The Court has found that the term is used in the sense

of the ultimate substantive issues of a litigation, *Angel v. Bullington*, 330 U.S. 183, 190 (1947), and that a court's conclusion that it lacks jurisdiction over a particular action is not an adjudication "on the merits," whereas a determination that the plaintiff had failed to state a claim upon which relief could be granted is an adjudication "on the merits." *Bell v. Hood*, 327 U.S. 678, 682 (1946). Lower courts have found that an adjudication "on the merits" had not taken place where the defendants had never been put on trial before a trier of fact. *U.S. v. Kendrick*, 853 F.2d 492, 496 (6th Cir. 1988). *See also Weston Funding Corp. v. Lafayette Towers*, 550 F.2d 710, 715 (2d Cir. 1977); *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1130-31 (2d Cir. 1976). Here, where the Tenth Circuit limits judicial review in the District Court to the administrative record (and, indeed, to only that part of the administrative record the Director selects) and prohibits a *de novo* proceeding, it has effectively deprived the District Court of the jurisdiction and capacity to *be* a "trier of fact" or to resolve the ultimate issues of the litigation, i.e., whether in fact there was a statutory basis for the appointment of a conservator. In short, under the Tenth Circuit's construction of the law, there cannot be a decision "on the merits" in the District Court as that term is commonly understood.

The Due Process Clause

On the plain meaning of the statute alone, then, the Tenth Circuit erred and should be reversed. But the magnitude of the error is compounded by the court's failure to pay due heed to constitutional considerations. It is a given that the courts should read

statutes in such a way as to avoid a construction that would make the statute unconstitutional unless such construction is *plainly* contrary to the intent of Congress. *Edward J. DeBartolo Corp. v. Florida Coast Building & Construction Trades Council*, 485 U.S. 568, 575 (1988); *Hooper v. California*, 155 U.S. 648, 657 (1895). If the Tenth Circuit's reading of the statute here in issue is correct, then the statute is unconstitutional under this Court's Due Process precedents.

In any due process challenge to a statute, it is critical, first, to decide if there is a deprivation of a "significant property interest." *Fuentes v. Shevin*, 407 U.S. 67, 86 (1972). In this case, that is virtually incontestable. Just last term, this Court had occasion to decide that a mere attachment lien on real property involved a significant property interest deprivation. *Connecticut v. Doehr*, 111 S. Ct. 2105, 2113 (1991). Here, the government seized the savings association entirely.

Once it is determined that a significant property interest is at stake, there is a three-part test for determining what process is due. The courts are required to consider (i) the private interest that will be affected by official action; (ii) the risk of erroneous deprivation of such interest through the procedures used and the probable value of additional safeguards; and (iii) the government's interest. *Mathews v. Eldridge*, 424 U.S. 319, 335 (1976). *See also Connecticut v. Doehr*, 111 S. Ct at 2112.

The second of these factors is critical here. That there is a risk to Franklin here of an erroneous deprivation of its property interest should be self-evident in that the District Court found, in fact, that there

had been an erroneous deprivation. Nevertheless, the Tenth Circuit concluded that the District Judge should not have listened to the facts that led to that conclusion. That there is probable value to Franklin of safeguards in addition to the ones allowed by the Tenth Circuit is likewise self-evident, in that the District Court, having adopted those safeguards, ruled in favor of Franklin. When the Tenth Circuit concluded that those additional safeguards were not authorized by the statute, it directed the District Court to dismiss Franklin's action. If the presence or absence of particular safeguards is conclusive as to the outcome of litigation, as it clearly was here, it is hard to argue that there is no probable value to those safeguards.

The Conflict in the Circuits

This due process analysis was recently applied by the First Circuit in *Reardon v. United States*, 947 F.2d 1509 (1st Cir., October 29, 1991) (en banc), with a result directly contrary to the Tenth Circuit's decision in this case. Though *Reardon* arose under an unrelated statute, the similarities are striking, and it is clear from the respective results that the courts are in need of further guidance as to the proper application of the *Mathews v. Eldridge* analysis of due process claims.

In *Reardon*, the U.S. Environmental Protection Agency filed a lien on several parcels of real property in order to protect its rights to recover the cost of cleaning up PCB contamination of the land. The lien was filed without notice and without prior hearing. The plaintiffs, owners of the land, filed suit to have the lien set aside. They claimed that the lien was

overbroad, in that it placed restraints even on parcels of their land that were not contaminated, and that in any event they were "innocent landowners" and not responsible for the costs of cleanup. The First Circuit concluded that the governing statute, the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (42 U.S.C. § 9613(h)) deprived federal courts of the jurisdiction to consider such challenges—just as, in this case, the applicable statute as construed by the Tenth Circuit prevents the courts from entertaining the kind of full blown challenge to government action attempted by Franklin. The First Circuit went on to hold that that deprivation of an opportunity for a hearing violated the due process clause of the fifth amendment.

The court considered first the deprivation of a significant property interest, and found that the filing of a lien on the property fit the bill. Here, of course, the deprivation is much greater, in that the Office of Thrift Supervision unilaterally deprived the shareholders of their interest in Franklin entirely.

In *Reardon*, the court next considered the risk of current procedures and value of additional safeguards, comparing those cases where the issues are essentially uncomplicated and lend themselves to documentary proof, with those that are "highly factual" (*Reardon v. United States*, 947 F.2d at 1519). The court found that the issues were extremely fact-intensive, thereby demonstrating that there would be value to additional safeguards.

Here, of course, the entire thrust of Franklin's challenge is factual. The accounting practices and standards involved in the very complicated, almost unique, dealings of Franklin were the subject of an 18-day

trial in District Court, featuring highly qualified expert witnesses on both sides, taking diametrically opposed views of the issues (*See* Pet. App. at 19a). The *Reardon* court concluded that, in such a fact-intensive case, due process requires a meaningful hearing; the Tenth Circuit in this case concluded that the District Court should not have bothered to hear expert witnesses and judge their credibility, but rather that due process required only a review of selected portions of the Director's administrative record.

The First Circuit then weighed the government's interest in the balance, including "exigent circumstances" and the "fiscal and administrative burdens that the additional or substitute procedural requirement would entail," and found those factors less than compelling. In this case, as in *Reardon*, a real post-deprivation hearing would not in any way impede the fundamental governmental purpose. In *Reardon*, any liability for cleanup costs could be imposed upon subsequent owners, so there would have been no loss to the EPA from an inability or a delayed ability to file a lien during ownership by the plaintiffs. Here, the conservatorship placed Franklin in the hands of the Office of Thrift Supervision until such time as a court determined (if it did) that the conservatorship was improper.

CONCLUSION

This Court has held that the due process clause of the Fifth Amendment requires that persons deprived or to be deprived of a significant property interest must be afforded a meaningful opportunity to be heard on the matter at a meaningful time. *Mathews v. Eldridge*, 424 U.S. at 335. The Tenth Circuit's decision

deprives the Petitioner of that right, while a contemporaneous decision by the First Circuit, in a case less compelling than this one, affords that basic right. This Court should grant the Petition for Writ of Certiorari in order to harmonize the application of the *Mathews* test among the Circuits.

Respectfully submitted,

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February 10, 1992

OPPOSITION

BRIEF

FILED
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No. 91-1139

In the Supreme Court of the United States

OCTOBER TERM, 1991

FRANKLIN SAVINGS ASSOCIATION, ET AL., PETITIONERS

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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QUESTION PRESENTED

Whether the court of appeals correctly held that there was no justification for going beyond the administrative record in reviewing the decision of the Director of the Office of Thrift Supervision to appoint a conservator for petitioner Franklin Savings Association.

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In the Supreme Court of the United States

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FRANKLIN SAVINGS ASSOCIATION, ET AL., PETITIONERS

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-41a) is reported at 934 F.2d 1127. The decision of the district court (Pet. App 44a-116a) is reported at 742 F. Supp. 1089.

JURISDICTION

The judgment of the court of appeals was entered on May 28, 1991. A petition for rehearing was denied on September 10, 1991. Pet. App. 42a-43a. On November 27, 1991, Justice White extended the time for filing a petition for a writ of certiorari to January 8, 1992, and

the petition was filed on that date. This Court's jurisdiction is invoked under 28 U.S.C. 1254(1).

STATEMENT

On February 15, 1990, the Director of the Office of Thrift Supervision (the "Director" of "OTS") appointed the Resolution Trust Corporation as conservator for petitioner Franklin Savings Association ("Franklin Savings"), a financially distressed, federally insured thrift institution.[1] Petitioners, Franklin Savings and its parent corporation, challenged the Director's action. The district court ordered the Director to remove the conservator, but the court of appeals vacated that order.

1. Prior to 1981, Franklin Savings was a traditional federally insured savings association that relied on deposits by individuals and businesses to make single family mortgage loans. In 1981, Franklin Savings adopted what it called "innovative operating strategies" and "nontraditional pursuits." Over the next eight years, Franklin Savings' assets grew from $200 million to more than $11 billion. In the early stages of this growth, Franklin Savings invested in underpriced mortgage-backed securities (MBS), which entitle the holder to a share in the payments from a fixed pool of mortgage loans. By the mid-1980s, Franklin was pursuing its investment objectives with higher-risk and more volatile MBS derivatives, which entitle the holder to only part of the mortgage payment (*e.g.*, "principal only") and have a thin secondary market. By June 30,

[1] Congress established the Office of Thrift Supervision in 1989 and gave it responsibility for the examination, supervision, and regulation of all federally insured savings associations. OTS replaced the Federal Home Loan Bank Board. See Financial Institutions Reform, Recovery and Enforcement Act, Pub. L. No. 101-73, §§ 301, 401, 103 Stat. 277, 354; 12 U.S.C. 1462a, 1437 (Supp. I 1989).

1989, the stated value of Franklin's MBS derivatives and "junk bonds" was $3.6 billion, or 35% of its total asset base. Pet. App. 3a-4a, Trial Exh. 2001 (Exh. 6, at 4).

Franklin Savings also turned from local depositors to nationally solicited brokered deposits, which present two problems. First, brokered deposits are costly because they carry a higher than normal interest rate and require the payment of a commission. Second, brokered deposits are short term, consisting of what is known as "hot money," and can severely strain an institution's liquidity since it must continuously find cash to pay depositors as their certificates mature. Congress has condemned reliance on brokered deposits as indicative of "poor management." H.R. Rep. No. 54 101st Cong., 1st Sess. Pt. 1, at 299 (1989). By December 31, 1989, Franklin Savings' brokered deposits had increased to $3.3 billion, or 70.7% of its total deposits. Pet. App. 4a, 26a.

Franklin Savings lost more than $58 million during the 15-month period ending on December 31, 1989. Moreover, the Director determined that Franklin Savings was facing losses of more than $300 million. Franklin Savings had nevertheless paid its eight executive officers $3.5 million ($1.8 million in bonuses) and had paid dividends of approximately $15 million during 1988 and 1989. Pet. App. 5a. The court of appeals concluded that "[a] review of the administrative file clearly reveals a high-flying, debt-laden troubled savings and loan," in which the owners were "diverting millions of dollars into their pockets through large salaries, bonuses and dividends, notwithstanding the losses being incurred by the association." *Id.* at 40a.

These problems came to light as a result of the disclosures made by Franklin Savings in the Form 10-K that it filed with the Securities and Exchange

Commission and the Federal Home Loan Bank Board on June 30, 1989, and the Director's October 1989 examination of Franklin Savings. Petitioners were well aware of the Director's concerns: during the course of the 1989 examination "there had been numerous meetings, telephone calls, and correspondence between Director and Franklin relating to the numerous problems found by Director," and the Director "also issued specific directives to Franklin to deal with these concerns but Franklin was either unable or unwilling to comply with the directives." Pet. App. 7a.

When Franklin Savings failed to satisfy the Director's concerns, he appointed a conservator on February 15, 1990. Pet. App. 8a. The statutory basis for the Director's action was 12 U.S.C. 1464(d)(2)(E)(Supp. I 1989),[2] which provided that "[i]f, in the opinion of the Director, a ground for the appointment of a conservator * * * exists, the Director is authorized to appoint ex parte and without notice a conservator." More specifically, the appointment of the conservator was based on three of the grounds set forth in former 12 U.S.C. 1464(d)(2)(C)(Supp. I 1989): the Director found that (1) Franklin Savings was in an unsafe and unsound condition to transact business; (2) Franklin Savings had or was likely to incur losses that would deplete all or substantially all of its capital and there was no reasonable prospect for its capital to be replenished without federal assistance; and (3) there was a violation or violations of laws or regulations or an unsafe and unsound condition which was likely to cause insolvency or substantial dissipation of assets and earnings, or was

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[2] Section 1464(d)(2)(E) was redesignated Section 1464(d)(2)(B) in 1991, effective December 1992. FDIC Improvement Act of 1991, Pub. L. No. 102-242, § 133 (d) and (g), 105 Stat. 2271, 2273. Like the court of appeals and petitioners, see Pet. 2 n.1, we will refer to the provision as Section 1464(d)(2)(E).

likely to weaken Franklin Savings' condition. Pet. App. 7a.

2. Petitioners challenged the appointment of the conservator pursuant to Section 1464(d)(2)(E), which provided that "[i]n the event of such appointment, the association may, within 30 days thereafter, bring an action in the United States district court * * * for an order requiring the Director to remove such conservator or receiver, and the court shall upon the merits dismiss such action or direct the Director to remove such conservator or receiver." The Director accordingly filed with the United States District Court for the District of Kansas the three-volume administrative record containing all materials that were before him when he made his decision, and certified this record to be complete and correct.

The district court, however, decided to "consider evidence outside the administrative record." Pet. App. 51a. In fact, the district court held an 18-day trial at which it "heard live testimony from twenty-five witnesses; accepted deposition testimony from eighteen witnesses; [and] received over 650 trial exhibits." *Id.* at 19a, 44a. The district court, which said that it was applying a "hybrid standard of review," acknowledged that the statute "does not provide for *de novo* review, but for review on whether the agency's action was based on statutory grounds or was arbitrary and capricious or an abuse of discretion." *Id.* at 51a-52a. However, after reviewing all of the evidence the district court "engaged in credibility determinations regarding competing experts [and] basically made its own findings, compared those to the findings of Director, and decided the conservator was wrongly appointed." *Id.* at 19a.

3. The court of appeals vacated the district court's judgment and remanded with instructions to dismiss

the action. Pet. App. 41a. With respect to the scope of review under Section 1464(d)(2)(E), the court concluded that in most instances review should be confined to the administrative record. Pet. App. 12a. In reaching that conclusion, the court noted that the statute, "while clearly authorizing judicial review of the director's decision, fails to specifically define the scope of that review." *Id.* at 11a. "In cases where Congress has provided for judicial review without setting forth the standards to be used or procedures to be followed in conducting that review," the court continued, this Court has advised that "such review shall be confined to the administrative record and, in most instances, no de novo proceedings may be had." *Id.* at 12a, citing, among other cases, *Camp* v. *Pitts*, 411 U.S. 138, 142 (1973); *Citizens to Preserve Overton Park* v. *Volpe*, 401 U.S. 402, 419-420 (1971); and *United States* v. *Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963) (footnote omitted).

In this case, the court of appeals concluded, it made sense to follow the normal approach. The statute "establishes that the determination of whether the statutory grounds to appoint a conservator exist lies in the province of the *director's opinion.*" Pet. App. 11a-12a. In addition, Congress did not mandate specific procedures, but instead directed the Director to rely on his opinion, because "it expects the director to be vigilant and responsive"; quick action may be needed because "[i]f there is inadequate capital to absorb losses, the losses fall upon the FDIC, and if these funds are depleted, then upon taxpayers." *Id.* at 12a. The court of appeals concluded that "[t]he close supervision, broad discretion, and quick response directed by [the statute] dictate[] a narrow and limited scope of review that gives deference to the director's judgement, knowledge, and expertise." *Ibid.*

At the same time, the court of appeals stressed that it is appropriate to go outside the administrative record in some cases. The court said that it would be appropriate for a reviewing court to consider additional evidence in three sorts of cases: (1) "[w]here the administrative record fails to disclose the factors considered by the agency"; (2) "where necessary for background information or for determining whether the agency considered all relevant factors including evidence contrary to the agency's position"; and (3) "where necessary to explain technical terms or complex subject matter." Pet. App. 13a. But no such circumstances were presented here. To the contrary, the court of appeals concluded that the Director made "formal findings and produced and certified a voluminous and detailed agency record for review that would enable the reviewing court to conduct a substantial and meaningful review from the agency record." *Id.* at 15a.

The court of appeals specifically addressed and rejected petitioners' claim that its views were not adequately presented by the administrative record. "In making these assertions," the court said, "Franklin ignores the substance of the agency record, which contains numerous recitations of Franklin's views and reasons therefor." Pet. App. 17a. The court also concluded that "[t]he record shows [that] Franklin had numerous opportunities to present its views and that those views were considered by Director." *Ibid.*

Turning from the scope of review to the standard of review, the court of appeals held that the district court had "articulated the standard of judicial review correctly" by stating that the decision to appoint a conservator was to be set aside only if it was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Pet. App. 22a, quoting 5 U.S.C. 706(2)(A). However, the court of appeals concluded that

the district court's "actions in applying this standard resulted in error as it in fact applied a de novo review." Pet. App. 22a. After reviewing the Director's decision under the proper standard, the court of appeals concluded that the decision to appoint a conservator "was supported by substantial evidence and is in accordance with the applicable law." *Id.* at 41a.

ARGUMENT

Petitioners agree that review "under §1464(d)(2)(E) proceeds under the familiar arbitrary and capricious *standard* of review." Pet. 19. However, they argue that the district court properly expanded the *scope* of review beyond the administrative record by hearing from 25 witnesses, accepting 18 depositions, and receiving more than 650 exhibits. Pet. 15-24. Alternatively, petitioners argue that the administrative record should not be limited to the materials that the Director actually relied upon in making his decision to appoint a conservator, but should be expanded to include every document in the agency's files that directly or indirectly relates to the decision. Pet. 24-28. There is no warrant for review of those contentions since all three of the courts of appeals to have considered the issue have correctly agreed that the normal rule governing the scope of review of an administrative decision—review confined to the designated administrative record—applies under Section 1464(d)(2)(E) and the court of appeals specifically held that there was no need to go beyond the record in this case.[3]

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[3] In addition, the question presented does not affect nearly as many cases as petitioners suggest. See Pet. 3, 28-30. From February 1989 through December 11, 1991, OTS and its predecessor appointed conservators or receivers for 675 institutions, but only 21 of those decisions have been challenged in court. Of those challenges only seven, including this case, remain pending. The most recent public report of the Director stated that on September

1. The other courts of appeals to have considered the appropriate scope of review under Section 1464(d)(2)(E) have both concluded, like the court below, that review is normally limited to the administrative record. In *Guaranty Savings & Loan Ass'n* v. *FHLBB*, 794 F.2d 1339, 1342 (8th Cir. 1986), the court held "that the district court correctly restricted its review to the administrative record." In *Woods* v. *FHLBB*, 826 F.2d 1400, 1408 (5th Cir. 1987), the court similarly concluded "that Congress did not intend for the district court to review the Bank Board's decision *de novo*, but rather that the decision be reviewed on the basis of the administrative record." Both courts noted that in *United States* v. *Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963), this Court reiterated that "in cases where Congress has simply provided for review, without setting forth the standards to be used or the procedures to be followed, this Court has held that consideration is to be confined to the administrative record and that no *de novo* proceedings may be held." 826 F.2d at 1406; 794 F.2d at 1342.[4]

30, 1991, there were only 79 savings associations that OTS thought were likely to be placed in conservatorship or receivership in the foreseeable future. That number is in contrast to the 377 savings associations that were in this category on December 31, 1989. Dir., OTS Press Conference (Dec. 10, 1991).

[4] Petitioners contend, despite this agreement in the courts of appeals, that "[c]onsiderable confusion exists among district courts." Pet. 15. Of course, review by this Court generally is not warranted on account of disagreements among district courts. In any event, petitioners exaggerate the extent of that disagreement. The decision in *Fidelity Savings & Loan Ass'n* v. *FHLBB*, 540 F. Supp. 1374 (N.D. Cal.), was reversed by the court of appeals, which did not reach the scope of review issue. *Fidelity Savings & Loan Ass'n* v. *FHLBB*, 689 F.2d 803 (9th Cir. 1982). Although the district court's decision in *Telegraph Savings & Loan Ass'n* v. *FSLIC*, 564 F. Supp. 862 (N.D. Ill. 1981), was affirmed, the court of appeals

Like the court below, the Fifth and Eighth Circuits correctly rejected the primary argument petitioners advance in support of their claim that a district court should conduct de novo proceedings, which is that de novo review is required by the statute's direction that "the court shall upon the merits dismiss such action or direct the Board to remove such conservator or receiver." The Eighth Circuit explained in *Guaranty Savings* that "the 'upon the merits' language * * * merely means that the district court's decision to either dismiss the action or remove the appointed receiver should be based upon the merits of the action (i.e., whether statutory grounds for a receivership exist) rather than on procedural or policy oriented grounds." 794 F.2d at 1342. The Fifth Circuit and the court below both agreed with that conclusion. 826 F.2d at 1406; Pet. App. 14a.[5] The unanimous conclusion of the three courts

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did so on different grounds. 703 F.2d 1019 (7th Cir. 1983). In *Haralson* v. *FHLBB*, 721 F. Supp. 1344 (D.D.C. 1989), *Collie* v. *FHLBB*, 642 F. Supp. 1147 (N.D. Ill. 1986), *Washington Federal Savings & Loan Ass'n* v. *FHLBB*, 526 F. Supp. 343 (N.D. Ohio 1981), and *Lincoln Savings & Loan Ass'n* v. *Wall*, 743 F. Supp. 901 (D.D.C. 1990), the district courts ruled for the Director's predecessors and there was no appeal. In *Marietta Franklin Sec. Co.* v. *Muldoon*, 770 F. Supp. 1212 (S.D. Ohio 1991), appeal pending, No. 91-3930 (filed Sept. 22, 1991), the district court ruled for OTS and the plaintiff has appealed. And in *Gibralter Savings* v. *Ryan*, 772 F. Supp. 1290, 1293 (D.D.C. 1991), the district court with national jurisdiction over challenges to the appointment of conservators and receivers, 12 U.S.C. 1464(d)(2)(E)(Supp. I 1989), recently was "persuaded by the reasoning in *Franklin Savings*, *Woods*, and *Guaranty Savings* that the scope of review must be limited to the administrative record that was before the Director at the time the decision was made to appoint a receiver."

[5] The Eighth Circuit's decision in *Guaranty Savings* and the Fifth Circuit's decision in *Woods* were both issued prior to Congress's reenactment of Section 1464, including the phrase "upon the merits," in 1989. Since it is "appropriate to assume that

of appeals that have considered the issue is plainly correct. Nothing about the phrase "upon the merits" relates to the scope of review; an affirmance or a reversal upon the merits could be based either on an administrative record or on a de novo proceeding. But Congress's direction that the courts act "upon the merits" precludes the district courts, for example, from removing a conservator as a remedy for a procedural defect.[6]

Petitioners contend that Congress would have said that review is to be "on the record" if it meant to restrict the scope of review to the administrative record. Pet. 18. But that overlooks the general rule that "in cases where Congress has simply provided for review, without setting forth the standards to be used or the procedures to be followed, this Court has held that consideration is to be confined to the administrative record and that no *de novo* proceedings may be held." *United States* v. *Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963); see also Pet. App. 12a, 826 F.2d at 1406, 794 F.2d at 1342.

Moreover, in a case like this, involving informal adjudication, it is entirely appropriate for a reviewing court

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our elected representatives * * * know the law," *Cannon* v. *University of Chicago*, 441 U.S. 677, 696-697 (1979), it is appropriate to assume that Congress was aware of those decisions and agreed with them.

[6] Petitioners suggest that de novo review is called for because until 1966 an administrative hearing was required prior to the appointment of a conservator. Pet. 24 n.19. But in 1966 Congress declined to enact a proposal that would have authorized a reviewing court to "conduct a trial of the facts and the law in the case *de novo* and where appropriate upon the merits dismiss such action or direct the Board to remove such conservator or receiver." *Hearings on S. 3158 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency*, 89th Cong., 2d Sess. 324 (1966).

to go beyond the administrative record in certain limited circumstances, as the court of appeals recognized. Pet. App. 13a. Thus, where the factors considered by the agency are not apparent from the record; where the record does not disclose whether the agency considered evidence contrary to its position; and where more information is needed so that the district court can understand technical or complex subject matter, it is permissible to go beyond the record. *Ibid.* That may also explain why Congress provided for review in the district courts: where there is no administrative record resulting from a formal adjudication, some factfinding may be required in order to determine whether the agency acted arbitrarily or capriciously. But that is no warrant for a full-blown trial like the one the district court held in this case. Cf. *Camp* v. *Pitts*, 411 U.S. 138, 142 (1973) ("the focal point for judicial review should be the administrative record already in existence, not some new record made initially in the reviewing court").

Petitioners miss the mark in arguing, Pet. 23, that de novo review does not jeopardize the goals Congress sought to further through the statutes governing the savings and loan industry. While it is theoretically possible that a reviewing court could hold an 18-day trial, hear 25 live witnesses, review 18 depositions and more than 650 documents, and then review the agency's decision under the arbitrary and capricious standard, it is not surprising that after conducting such an extensive proceeding the district court "basically made its own findings [and] compared those to the findings of Director." Pet. App. 19a. As a result, the ultimate responsibility for determining whether a conservator should be appointed was transferred from the Director to the district court. But Congress vested "the responsibility for determining the quality of assets, the proper

levels and types of assets and liabilities, appropriate accounting standards, and the numerous other questions relating to the safe and sound condition of a financial institution" in the Director. *Id.* at 40a. The district court improperly substituted its judgment for that of the Director in these matters for which Congress has assigned responsibilities to the Director. The court of appeals has, on proper analysis, corrected the trial court's error.

2. As a fall-back, petitioners contend that even if a full-blown trial is not mandated by Section 1464(d)(2)(E), due process required the district court in this case to go beyond the administrative record designated by the Director because, they claim, the Director excluded documents supporting their position from the designated record. There is no dispute on the legal point raised by petitioners. The court of appeals acknowledged that a reviewing court could go beyond the administrative record in certain circumstances, specifically including "where necessary for background information or for determining whether the agency considered all relevant factors including evidence contrary to the agency's position." Pet. App. 13a. We agree.

But the court of appeals correctly concluded in this case that petitioners had ample opportunity to be heard and that the designated administrative record was adequate. "The record shows Franklin had numerous opportunities to present its views and that those views were considered by Director." Pet. App. 17a. The designated record "contained voluminous data" that reflected the extensive submissions Franklin Savings made to OTS. *Ibid.*[7] Accordingly, the court of appeals

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[7] Moreover, the court of appeals recognized that Franklin was not seeking an evidentiary hearing to dispute the accuracy of the data on which the Director relied, but to contest "basic policy decisions, such as whether the degree of Franklin's reliance upon

correctly concluded that petitioners had a full opportunity to present their positions during the examination and that the administrative record reflected their positions.

Finally, the court of appeals specifically rejected petitioners' claim that "the agency record is one-sided." Pet. App. 17a. And it made that determination against the backdrop of the 18-day trial conducted by the district court, where petitioners were able to introduce all of the evidence they claimed had been improperly excluded from the administrative record. In short, there is no warrant for review by this Court of petitioners' factbound claim that the administrative record was inadequate in this case.

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brokered deposits constitutes an unsafe or unsound practice," and the Director's predictive judgments concerning expected losses and depletion of capital. Pet. App. 18a, 33a. Due process does not require a trial de novo of such issues. "The judicial model of an evidentiary hearing is neither a required, nor even the most effective, method of decisionmaking in all circumstances." *Mathews* v. *Eldridge*, 424 U.S. 319, 348 (1976).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 91-1139

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Petitioners,

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, and
THE UNITED STATES OF AMERICA,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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REPLY BRIEF FOR PETITIONERS

The question presented in this case is whether § 1464 (d)(2)(E) requires that owners of a seized savings and loan be given an opportunity to present evidence opposing the seizure in their action before the district court. The petition demonstrates that this is a question of national importance, one that has already generated substantial confusion in the courts and that is bound to recur frequently.

In opposing certiorari, respondents primarily offer distractions [1] and say little to deny the importance of the issue presented. They claim that they are likely to seize "only" 79 institutions "in the foreseeable future." Opp. 8 n.3. But more recent statements of regulators double the predicted number.[2] And even if the correct number were closer to 79, respondents ignore the fact that the

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[1] Respondents' brief is replete with euphemisms: Respondents redesignate ordinary, regularly-scheduled examinations of banking operations as "informal adjudication" (Opp. 11), they refer to the Director's perfunctory issuance of his seizure "opinion" as "formal findings" (Opp. 7), and they quote the wholly unsupported and inappropriate libel which the Tenth Circuit adopted wholesale from the OTS's brief below (Opp. 3). This last is particularly unseemly.

Respondents repeat OTS's disingenuous assertion—made for the first time in the appellate stages of these proceedings—that Franklin was a " 'high-flying, debt-laden troubled savings and loan,' in which the owners were 'diverting millions of dollars into their pockets . . . notwithstanding the losses being incurred by the association.' " (Opp. 3, quoting Pet. App. 40a.) While this Court might be reluctant to grant review of a case involving a truly mismanaged thrift, this is not that case. As petitioners noted (Pet. 11), the district judge, who listened to the opinions of experts and observed the testimony of Franklin's managers and owners, concluded that this was "not a case involving an infamous or notorious savings and loan" and was "not a case involving fraud, corruption or self-dealing by the management or directors of Franklin. There has been no allegation or even hint of illegal or unethical conduct."

[2] Knight & Schmidt, *U.S. Shifts Bank, S&L Strategies*, Washington Post, Dec. 8, 1991, at A-22.

Tenth Circuit's decision is equally applicable to the seizures of commercial banks.[3] See Pet. 29; Brief of American Banking Association, et al., as *amici curiae*, at 2 (explaining that 12 U.S.C. § 1821(c)(7) contains language identical in relevant respects to § 1464(d)(2)(E)). In short, respondents cannot credibly argue that the process for adjudicating challenges in the district courts to ex parte seizures of banks and savings and loans is not a question of pressing national importance.

Respondents oppose certiorari chiefly on two other grounds, neither of which is reason to deny the petition. First, respondents argue that the confusion in the circuits is not sufficient to justify this Court's review. (Opp. 9 n.4.) Although, as petitioners demonstrate below, respondents have overstated the degree of harmony in the lower courts, the dispositive point here is that there is no need for the Court to await an outright circuit conflict on an issue of immediate and pressing importance. Second, respondents offer various arguments to the effect that the Tenth Circuit's decision is correct on the merits. (Opp. 12-14.) None of these arguments, which are in any event better directed to briefing on the merits, provides a persuasive basis for denying certiorari.

1. Respondents suggest that this Court's review is unnecessary because the Tenth Circuit's construction of Section 1464(d)(2)(E) is consistent with that of two other courts of appeals. Opp. 9 & n.4 (quoting *Woods* v. *FHLBB*, 826 F.2d 1400 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988) and *Guaranty Sav. & Loan Ass'n* v. *FHLBB*, 794 F.2d 1339 (8th Cir. 1986)). But a review of the facts in those cases, which respondents neglect entirely, demonstrates that neither court adopted the extreme interpretation advanced by the Tenth Circuit. In *Woods*, the court of appeals observed that (1) the Board had conducted a hearing on a cease and desist order at

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[3] Knight & Schmidt, at A-1 ("The FDIC is predicting the failure of at least 200 banks with $86 billion in assets for 1992").

which the management of the thrift had a full and fair opportunity to present its case; (2) the Board also placed before the district court "the entire administrative record" and the owners were afforded the opportunity in the district court to submit "a multi-volume exhibit and affidavits in opposition to the Bank Board's position"; and (3) the institution had ample notice that the Board was considering a conservatorship. See 826 F.2d at 1412-13. Respondents' interpretation of § 1464(d)(2)(E) would require none of these elements, even though the *Woods* court found them dispositive of the institution's due process claims. *Id.* Franklin certainly had none of these opportunities or any such notice prior to its seizure.

Similarly, respondents quote but then ignore the *holding* in *Guaranty Savings*, which is merely that de novo review is not appropriate. But that is a red herring. Petitioners did not request a de novo hearing. What they requested was a meaningful opportunity to be heard at a meaningful time as to the inaccuracies in the designated record. The Director had not afforded them that opportunity and therefore they asked for it before the district court. Nothing in *Guaranty* remotely supports the extreme holding of the Tenth Circuit.

Moreover, the confusion among the district courts described in the petition is not dispelled by respondents' observations about who won or lost the cases. (Opp. 9 n.4.) The fact is that courts have followed diverse procedures in adjudicating actions brought under § 1464(d)(2)(E) (Pet. 15-17). And courts continue to declare that respondents' interpretation of § 1464(d)(2)(E) abrogates due process principles. *Marietta Franklin Sec. Co.* v. *Muldoon*, 770 F. Supp. 1212, 1220-21 (S.D. Ohio 1991) (concluding after review of the cases interpreting § 1464(d)(2)(E) that the parties should be allowed to supplement the Director's record). Whether a majority of courts ultimately rejected the financial institutions' challenges is irrelevant to the issue presented here—how

to interpret § 1464(d)(2)(E) in light of the requirements of due process.

2. The plain language of § 1464(d)(2)(E) will not support respondents' repeated attempts to characterize the district court's task as traditional "judicial review" of administrative decisionmaking. Congress did not put the word "review" in § 1464(d)(2)(E); instead, it states that owners of a seized financial institution may bring "an *action* in the United States district court" against the OTS and "the court shall *upon the merits* dismiss such action or direct the Director to remove [the] conservator or receiver." (Emphasis added.)

Nor, obviously, are respondents correct in asserting that § 1464(d)(2)(E) is entirely silent as to the standards to be used or the procedures to be employed. (Opp. 11.) For this reason, § 1464(d)(2)(E) does not fall within the rule of *United States* v. *Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963). That rule states that "in cases where Congress has simply provided for review, without setting forth the standards to be used or the procedures to be followed, this Court has held that consideration is to be confined to the administrative record and that no *de novo* proceedings may be held." Here, however, Congress has specified a procedure (an "action") to be commenced in a particular forum, the district court, whose adjudication is to focus "upon the merits."

Moreover, the *Carlo Bianchi* line of cases itself reveals that the rule advanced is not applicable here. None of the statutes at issue in these cases contains provisions which match § 1464(d)(2)(E) in specificity. See *Carlo Bianchi*, 373 U.S. at 710 n.1 (statute provides only that agency decisions on government contracts shall be final unless arbitrary, capricious, fraudulent or unsupported by substantial evidence); *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 405 n.3 (1971) (statute contained no provision for judicial review, so the Court applied APA review procedures); *Camp* v. *Pitts*, 411 U.S. 138, 139-140 (1973) (same). Cf. *Chandler* v.

Roudebush, 425 U.S. 840, 862 n.37 (1976) ("where Congress intends review to be confined to the administrative record, it so indicates").

Respondents agree with petitioners that "upon the merits" means that the district court's decision should be "based upon the merits of the action (i.e. whether statutory grounds for [appointment] exist)." (Opp. 10, Pet. 18.) The fact that the statute does not "specifically define the scope of review" (Opp. 6) is not a license for the government to rewrite the statute to provide for "on the record" review of the Director's selected supporting documents. Given the lack of any meaningful due process protection prior to the seizure, fundamental principles of due process require that § 1464(d)(2)(E) be construed to permit the district court to hear management's side of the case.

3. Respondents also err in their claim that "on the record" review in the district court constitutes all the process that was due to petitioners. Respondents offer that "Franklin had numerous opportunities to present its views and these views were considered by Director" (Opp. 13, quoting Pet. App. 17a) and that these proceedings "involv[ed] informal adjudication." *Id.* at 11. In fact, no adjudication, informal or otherwise, took place before OTS.

Petitioners were subjected to regular examinations by OTS officials. During these examinations ordinary inquiries were made by examiners into various financial operations. The individuals answering had no knowledge that a record was being made, much less that the agency was contemplating use of the most extreme sanction within its power—the seizure of the institution's assets.[4] Petitioners had no meaningful opportunity to present evi-

[4] Although respondents maintain that the designated record " 'contains voluminous data' that reflected the extensive submissions Franklin Savings made to the OTS" (Opp. 13, quoting Pet. App. 17a), it is noteworthy that prior to the district court hearing, OTS

dence to the Director that their conduct conformed completely with generally accepted accounting principles, that they satisfied all capital requirements, and that they were operating in a safe and sound fashion.[5] Respondents' characterization of its routine examinations as "informal adjudication" is therefore gross hyperbole. The fact remains that, under respondents' interpretation of § 1464 (d)(2)(E), there is absolutely no reliable check against mistaken decisions to appoint conservators or receivers.

The "action" in district court is the first and only opportunity for an institution to present its case in defense. The due process principles at work here are simple: (1) the less predeprivation process available, the greater the process that must be afforded post-deprivation, see *Cleveland Bd. of Educ.* v. *Loudermill*, 470 U.S. 532, 545 (1985); and (2) the greater the private interest affected, the greater the risk of erroneous deprivation; and (3) the more substantial the government's interest, the more extended the process must be. See *Mathews* v. *Eldridge*, 424 U.S. 319, 333 (1976). The Tenth Circuit, however, has narrowed that process to nothing more than a review of what is, in effect, the Director's brief and appendices. It suffices under the statute, according to the court of appeals, for the agency to include in the designated record "summaries" or "recitations" of what-

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submitted an additional 17 volumes of "designated record," a clear indication that even OTS recognized that the "designated record" was not sufficient to withstand scrutiny. The district court refused its admission. *See Franklin Sav. Ass'n* v. *Director*, 740 F. Supp. 1535 (D. Kan. 1990).

[5] Indeed, respondents' labelling of Franklin as "financially distressed" (Opp. 2) is deceptive. Franklin always exceeded every regulatory capital requirement, as illustrated in each of its publicly filed statements (forms 10Q and 10K) and the district court's findings. Pet. 6-7. The district court also found that Franklin has an economic value of $378 million, which was not less than its GAAP capital and that Franklin continued to earn a profit and was likely to continue to do so in the future. Pet. App. 104a-105a.

ever submissions the institution's owners may have made that may be contrary to the agency's position. Pet. App. 17a. This Court's holdings as to what constitutes a "meaningful opportunity" to respond to adverse governmental action demonstrate that such perfunctory review is inadequate. See *Brock* v. *Roadway Express, Inc.*, 481 U.S. 252, 261 (1987) (meaningful opportunity to respond requires an opportunity to present oral and written responses, including affidavits and supporting documents); *Arnett* v. *Kennedy*, 416 U.S. 134, 170 (1974) (opinion of Powell, J.) (right to be heard includes right to submit evidence).

Respondents further attempt to distract this Court from the due process concerns raised by the Tenth Circuit's interpretation of § 1464(d)(2)(E) by repeatedly claiming that the district court acted excessively by conducting an extended trial in this case (Opp. 8, 12, 14).[6] But even if that argument is accepted, it provides no basis for concluding, like the court of appeals, that *no*

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[6] Respondents make a related claim that after an 18-day trial, "the district court basically made its own findings [and] compared those to the findings of the Director." (Opp. 12, quoting Pet. App. 19a.) A review of the district court's opinion reveals something different. The district judge, deferring to the administrative expertise of OTS, presumed the correctness of OTS's conclusions and received evidence in rebuttal. Pet. App. 48a. Finding the presumption rebutted, the district court had no obligation to accept the Director's findings. *See Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (notwithstanding deference, "agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made"). "Deference" does not mean wholesale acceptance. *See id.* And, even if there were independent findings, the Tenth Circuit affirmed the district court's crucial finding on the central issue in dispute during the 18-day proceeding, whether Franklin's accounting standards comported with GAAP. Pet. App. 37a-38a.

proceedings need be conducted by a district court even though there has never been an opportunity for any kind of hearing before the OTS. A supposed *excess* of process by the district court does not resolve the question as to whether the Tenth Circuit's process meets *minimum* requirements.

4. The court of appeals reasoned that its extremely limited interpretation of § 1464(d)(2)(E) was permissible under due process principles because a challenging party could invoke three exceptions to persuade the district court to go beyond the record. Pet. App. 13a. These exceptions obtain where: (1) the factors considered by the agency are not apparent from the record; (2) the record does not disclose whether the agency considered evidence contrary to its own position; and (3) more information is needed so that the district court can understand a technical or complex subject matter. Respondents err, for at least two reasons, in relying upon the court of appeals' purported exceptions.

First, the existence of these exceptions presumes that an adequate record has been compiled in the first place. In each of the cases relied upon by the Tenth Circuit and respondents (Pet. App. 13a, Opp. 12), the agency held predeprivation proceedings directed at the ultimate question before the agency and compiled a record containing the concerned parties' own arguments and submissions. See *Thompson* v. *United States Dep't of Labor*, 885 F.2d 551, 555-56 (9th Cir. 1989) (describing proceedings before the ALJ and review by the Secretary); *Animal Defense Counsel* v. *Hodel*, 840 F.2d 1432, 1436 (9th Cir. 1988) (administrative record was "fully developed and open for public comment" prior to agency's decision), *corrected*, 867 F.2d 1244 (9th Cir. 1989).

Under respondents' construction of § 1464(d)(2)(E), however, no such administrative record is compiled on the ultimate question of whether a receiver or conservator should be appointed for a financial institution. OTS

simply gathers information during its regularly scheduled examinations from parties unaware of OTS's ultimate intent—a far cry from the compilation of a traditional judicial or administrative record.

Second, respondents' attempt to borrow the exceptions set forth in *Thompson* and *Animal Defense Counsel* is a make-weight argument in this case. Respondents' simply ignore petitioners' point (Pet. 25 n.20) that the Tenth Circuit's holding in this case itself proves that the exceptions as understood by the court of appeals are inadequate to provide due process. The Tenth Circuit, hewing to a designated record despite numerous examples of missing contrary evidence and much confusion over complicated accounting methods, held that none of the exceptions was applicable.[7] If the exceptions did not authorize judicial proceedings beyond the designated record here, they are meaningless.

* * * *

In this case, the district court and the court of appeals employed widely divergent procedures, reflecting two distinct and widely followed interpretations of § 1464(d)

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[7] Notably, the district court specifically held, as an alternative ruling, that each of the three grounds for going beyond an administrative record was satisfied. Pet. App. 52a-53a. First, the district court found that the factors considered by the agency (which as stated by the Director, were nothing more than a paraphrase of statutory language) were not apparent from the record. Pet. App. 52a-53a. Missing from the record, for example, were notes or memoranda memorializing critical conferenecs and meetings. *See* Pet. 53a n.5. Second, the court found that the Director had not considered all relevant information; his staff had deliberately concealed a material statement made by Franklin's bond trustee on the eve of appointment to the effect that defeasance was not threatened with respect to Franklin's bonds. Pet. App. 74a-75a. Finally, the district court judge called for expert accounting testimony to clarify the dispute over accounting practices that was at the heart of OTS's claim that Franklin failed to meet its capital requirements. Pet. App. 54a. The court of appeals simply ignored all of this and limited its review to the designated record, even though all the parts of that record relevant to the agency action were proven false in the district court hearing.

(2)(E), in adjudicating petitioners' challenge to the OTS's appointment of a conservator. These courts reached diametrically opposite results. This case thus squarely presents an issue that is both timely and national in scope, and one whose resolution will affect not only savings and loans, but the entire commercial banking industry as well.

Respondents' arguments in opposition reveal an agency's efforts to consolidate fully the overwhelming authority that it has crafted for itself through litigation, despite plain statutory language which creates a substantial check upon that authority. The unfortunate advent of a savings and loan crisis in this nation has placed a heavy burden upon regulators, but the atmosphere of crisis only heightens the need for this Court to establish now some uniform treatment of actions filed under § 1464 (d)(2)(E) and statutes like it, and to protect the due process rights of the owners and stockholders of seized financial institutions.

CONCLUSION

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

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AMICUS CURIAE

BRIEF

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No. 91-1139

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

FRANKLIN SAVINGS ASSOCIATION and
FRANKLIN SAVINGS CORPORATION,
Petitioners,

v.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, and
THE UNITED STATES OF AMERICA,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF OF NATIONAL BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the court of appeals erred in holding that the scope of review under 12 U.S.C. § 1464(d)(2)(E), which provides for an "action" in district court to determine "upon the merits" the legality of a government seizure of a savings and loan institution, can be limited consistent with the commands of the statute and the Due Process Clause to documents designated for the record by the government, thereby precluding the district court from considering:

(a) any evidence submitted by the savings and loan's representatives, even though there was no prior opportunity to submit evidence concerning the grounds for the seizure because it was *ex parte* and without notice or prior proceeding; or

(b) the whole administrative record in existence at the time of the seizure.

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BRIEF OF NATIONAL BANKERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

The National Bankers Association ("NBA"), founded in 1927 as the National Negro Bankers Association, is the trade association of the nation's 106 minority and women-owned banks. Our members include banks owned by Asians, American and East Indians, African Americans, Hispanics, and Women. They service, in the aggregate, over one million depositors. These banks are lo-

cated primarily in urban areas, and provide the primary source of job creation and entrepreneurial capital for small businesses in minority communities.

In the decision below, the United States Court of Appeals for the Tenth Circuit concluded that a court reviewing the lawfulness of the government's decision to seize a savings and loan institution under 12 U.S.C. § 1464 (d)(2)(E), which requires that such a determination be made in "an action . . . upon the merits," is confined to considering only the evidence designated by the government agency and may not consider other evidence submitted by the institution—even when that evidence was also part of the administrative record before the agency. The parallel statute authorizing challenges to government seizures of commercial banks, 12 U.S.C. § 1821(c)(7), contains identical "upon the merits" language, and the decision below therefore has far-reaching consequences not only for savings and loan institutions but for commercial banks as well.

That decision renders meaningless the judicial review procedures that Congress established, and the Constitution requires, for the seizure of savings and loan institutions and commercial banks. The NBA is gravely concerned that the decision leaves such institutions with no effective protection against arbitrary agency action, and that it will have a particularly harmful effect on NBA member banks, whose access to capital will be severely inhibited by the uncertainty and added risk the decision generates for them and their investors.[1]

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[1] Pursuant to Rule 37.3 of the Rules of this Court, the parties have consented to the filing of this brief. The parties' letters of consent have been filed with the Clerk of this Court.

REASONS FOR GRANTING THE PETITION

The facts surrounding this case are fully set forth in the petition for certiorari, and *amicus* will not restate them in detail. On February 15, 1990, the Director of the Office of Thrift Supervision ("OTS") seized Franklin Savings Association ("Franklin") without giving it prior notice or the opportunity for a hearing of any kind. Franklin then filed this action in United States District Court seeking judicial review of the seizure, as the governing statute authorizes, "upon the merits." 12 U.S.C. § 1464(d)(2)(E). The district court concluded (Pet. App. 51a) that it was obligated to consider as evidence not only the specific documents submitted to it by OTS, but other exhibits and testimony relevant to the merits of the OTS decision as well. After considering such evidence, the court held (*id.* at 115a) that the agency had acted arbitrarily, capriciously, and without factual basis.

The court of appeals reversed. The court concluded that because "it is essential the director act promptly in appointing a conservator once he is of the opinion that a statutory ground exists," any subsequent judicial proceeding should be governed by "a narrow and limited scope of review." *Id.* at 12a. It therefore held that the only review that the statute (or the Constitution) requires is to determine whether the Director's "opinion"—which the court of appeals defined as "a belief held with confidence, not substantiated by direct proof or knowledge"—was rational. *Id.* at 12a, 38a. The court of appeals further held that a court reviewing a seizure decision is permitted to consider only the information reviewed by the Director in forming his opinion, *id.* at 17a-18a, and that the decision as to what information the Director must consider in forming his opinion is "left to his discretion." *Id.* at 16a. Because the district court had considered other evidence in addition to the evidence

designated by the Director, the court of appeals held that it had exceeded its authority.

The decision of the court of appeals poses a serious threat to the nation's financial institutions. The court held that the government may seize such an institution without ever being required to confront evidence contrary to its position as long as the agency failed or declined to consider that evidence in the first instance. This decision is contrary to both the statute it purports to construe and the due process clause of the United States Constitution. Moreover, it places savings and loan institutions and commercial banks in a highly precarious posture by exposing them to the potential for arbitrary seizure with no possibility of effective review. It thus introduces into the industry a substantial degree of uncertainty and risk, which will seriously inhibit investment—particularly investment in those smaller, less established institutions that principally serve minority communities in urban areas.

1. The court of appeals manifestly misconstrued the intent of Congress, which expressly required that subsequent review of a seizure decision be "upon the merits." The governing statute provides:

> If, in the opinion of the Director, a ground for the appointment of a conservator or receiver for a savings association exists, the Director is authorized to appoint ex parte and without notice a conservator or receiver for the savings association. In the event of such appointment, the association may, within 30 days thereafter, bring an action in the United States district court . . . for an order requiring the Director to remove such conservator or receiver, and the court shall upon the merits dismiss such action or direct the Director to remove such conservator or receiver.

12 U.S.C. § 1464(d)(2)(E). In authorizing the government to order immediate seizures without notice or hearing, while providing for after-the-fact judicial review on

the merits, Congress sought to effectuate two goals. It protected depositors by providing authority for swift and immediate action when their assets are at risk, and it safeguarded the due process rights of the institution by requiring subsequent and meaningful judicial review. Those objectives are not in conflict. Indeed, they are complementary; it is precisely *because* of the perceived need for the government to have the authority to take instant, *ex parte* action without any pre-seizure process that Congress established the right to post-seizure review on the merits.

The court of appeals, however, assumed that Congress' decision to authorize an initial seizure at the agency's broad discretion—based simply on an agency official's "opinion"—somehow applied to the post-seizure review process as well. It therefore held that, even after the institution has been seized, the court's task is simply to review the information relied upon by the Director to determine whether his opinion had a rational basis. Because the Director's determination of what information to rely upon is, under this decision, both left to his discretion and dispositive of the court's own scope of review, that standard inevitably guarantees that the Director's decision will be sustained.

This is a perverse misreading of the statute. The need for quick action in appointing a conservator was believed to justify aggressive and unilateral powers of seizure in the first instance. The agency is thus authorized to act immediately in order to protect depositors from the dissipation of their assets. These seizure provisions are constitutionally permissible, however, only because the institution is guaranteed full judicial review afterwards—at a time when, since a conservator has been appointed and is managing the institution, the "emergency" situation no longer exists.

The court of appeals thus erred in concluding that the need for the agency to take immediate action, and the

broad power given it to effect a seizure whenever the Director forms the requisite opinion, provides a basis for limiting the process granted the institution in the subsequent judicial proceeding. Exactly the opposite is the case. The potential for arbitrary agency action and erroneous seizures based upon misinformation is substantially heightened by the sweeping authority given the Director. The Director's power to seize institutions without notice is a basis not for truncating subsequent procedures, but rather for ensuring that the institution's right to meaningful judicial review is fully protected once the conservator is in place. That is why Congress balanced the grant of authority to make initial seizures, which is accomplished with virtually no procedural or substantive checks, with a post-seizure review "upon the merits" in a federal district court capable of making independent factual findings. For the court to hold that the absence of process *before* the seizure mandates a similar deprivation *after* the seizure is to turn the statute, and the due process clause, on their heads.

2. The judicial procedure established by the court of appeals for the seizure of financial institutions is not only contrary to the statute and the Constitution; it is also unprecedented in administrative and regulatory law. It is fundamental that when an individual or an institution is deprived by the government of property, it must be given the opportunity at *some* stage to present relevant evidence to demonstrate that the seizure is unlawful and to have that evidence considered. That opportunity may be given pre-seizure or post-seizure, but it must be granted in some form at some time.

In most agency adjudications, for example, a party is notified of the specific claims against it and permitted to submit evidence to the agency in response prior to the agency's decision. That party generally has no right to submit new factual evidence to the court of appeals on review, but the evidence it submits to the agency is

part of the record on appeal. If the agency has ignored relevant record evidence or responded insufficiently to that evidence, the court of appeals will order a remand so that the evidence may be given appropriate consideration.

Under the decision in this case, however, a financial institution is never given the opportunity to present evidence in its defense. It has no such opportunity when the matter is before the agency, because it is not given prior notice of the seizure and the claimed statutory grounds—it learns of the seizure only when the seizure takes place. And the institution has no such opportunity when the matter is before the district court, because the district court is then limited to reviewing only that portion of the record on which the agency states it relied.[2]

The term "administrative record" is thus a misnomer here. There is no "administrative record" because there have been no administrative proceedings to record. The "administrative record" in this case, which is typical of these cases generally, consisted of internal agency memoranda justifying the seizure, the institution's public filings, examination reports, and materials provided by the institution's accountants. It did not contain evidence from Franklin rebutting the Director's contention that specified statutory grounds existed to justify a seizure, because no such contention had been advanced at the time these documents were created. But see *Fuentes* v. *Shevin*, 407 U.S. 67, 81 (1972) ("No better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him

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[2] Nor does the agency have any obligation to consider any particular evidence before it, because "the decision of the director as to which information he must review to make an appointment decision should be left to his discretion." Pet. App. 16a. That discretion, in turn, is binding upon the court as well, because it is forbidden from going beyond the "administrative record"—defined as "the information *that* [*the director*] *relied upon in making his decision*." *Id.* at 18a (emphasis in original).

and [an] opportunity to meet it") (quoting *Joint Anti-Fascist Refugee Comm'n* v. *McGrath*, 341 U.S. 123, 171-72 (1951) (Frankfurter, J., concurring)). Even if such documents could have been submitted, the Director could have excluded them from the administrative record transmitted to the court by the simple expedient of not relying upon them.

Accordingly, under the interpretation of the statute set forth by the court of appeals, the institution is given absolutely no opportunity to rebut the charges against it. A statute should generally be construed, where fairly possible, so as to be constitutional. *Edward J. DeBartolo Corp.* v. *Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568, 575 (1988). The court of appeals in this case, however, misconstrued the statute in such a way as to render it unconstitutional—and then upheld it.

3. In his opposition to the petition, the Director appears to concede that the institution must at some point be given the opportunity to submit evidence rebutting the Director's charges and defending its position. Opp. 13. He notes, however, that the court of appeals stated as an exception to its holding that additional evidence could be submitted to the district court where necessary to determine "whether the agency considered all relevant factors including evidence contrary to the agency's position," (Pet. App. 13a), and contends that the court simply concluded that the three-volume record in this case was sufficiently "voluminous" to reflect adequately Franklin's position. *Id.* at 17a. The Director argues, therefore, that this case presents only the factbound question of whether it was necessary to go beyond the agency-designated record in this particular instance.

This argument is disingenuous. The issue in this case is whether an institution can be seized without ever being given the opportunity to present a legal or factual case rebutting the stated grounds for the seizure. Frank-

lin never had that opportunity at the administrative level because it was never given notice of the seizure. The routine filings it made prior to the seizure do not suffice because they were not directed to rebutting what ultimately became the agency's position. For a court to review the portions of the record designated by the Director and decide that, in *its* view, Franklin's position was nonetheless adequately represented is offensive to the adversarial system and to the constitutional guarantee of due process.

Moreover, such a statement is absurd on its face. In this case, the additional evidence the district court considered convinced it that the Director had acted arbitrarily and capriciously and had not properly considered the evidence contrary to his position. That evidence included both portions of the administrative record that the Director had not designated and evidence that had never been submitted to the agency. The court of appeals never held that the district court's factual findings were clearly erroneous; it held instead that the district court had improperly defined the scope of its review. This was a case, therefore, in which going beyond the agency-designated record *did* demonstrate that the agency had failed to consider properly "all relevant factors including evidence contrary to the agency's position," Pet. App. 13a, but the court of appeals held that the additional evidence should never have been considered. The court's purported exception to its rule confining review to the agency-designated record is therefore completely illusory. If such evidence was inadmissible in this case, it is impossible to imagine what hypothetical the court of appeals could have had in mind in suggesting that the admission of such evidence would in some instance be proper.

There is therefore nothing "factbound" about the legal issue presented by the petition. It will always be the case that the evidence an institution submits once it is informed of the seizure and the grounds therefor will be

different from the material it has submitted previously. Sometimes, as apparently happened here, that evidence will demonstrate that a mistake was made. The holding below establishes that such evidence may be—indeed, must be—ignored whenever the court determines on its own review of the agency-designated record that the institution's position was adequately represented. That such a determination will virtually always be made is shown both by the court of appeals' own description of the narrowness of this exception (Pet. App. 12a-13a) and by the fact that such a determination was made in this case in the face of the district court's contrary factual findings.

4. The uncertainty created by this decision for financial institutions is compounded by the more general disarray in the federal courts over the rules for review of government seizures. The procedure rejected by the court of appeals in this case, which permits the institution to introduce evidence while requiring it to show that the seizure was arbitrary and capricious, has been expressly adopted by federal courts in Illinois and Ohio. See *Marietta Franklin Sec. Co.* v. *Muldoon*, 770 F. Supp. 1212 (S.D. Ohio 1991); *Collie* v. *FHLBB*, 642 F. Supp. 1147 (N.D. Ill. 1986). Similar procedures have been adopted elsewhere. See *Lincoln Sav. & Loan Ass'n* v. *Wall*, 743 F. Supp. 901 (D.D.C. 1990); *San Marino Sav. & Loan Ass'n* v. *FHLBB*, 605 F. Supp 502 (C.D. Cal. 1984); see also *Washington Fed. Sav. & Loan Ass'n* v. *FHLBB*, 526 F. Supp. 343 (N.D. Ohio 1981). Other courts have gone further, and conducted *de novo* review of the agency decision. See *Telegraph Sav. & Loan Ass'n* v. *FSLIC*, 564 F. Supp. 862 (N.D. Ill. 1981), *aff'd sub. nom. Telegraph Sav. & Loan Ass'n* v. *Schilling*, 703 F.2d 1019 (7th Cir. 1983); *Fidelity Sav. & Loan Ass'n* v. *FHLBB*, 540 F. Supp. 1374 (N.D. Cal.), *rev'd on other grounds*, 689 F.2d 803 (9th Cir. 1982). The Tenth Circuit's approach thus stands at one extreme, but even the

courts that have taken other approaches are not consistent with one another.

Moreover, as the petition demonstrates (Pet. 25), the decision below approving reliance on only agency-designated portions of an administrative record is also in direct conflict with the decisions of numerous federal courts requiring consideration of an administrative record in its entirety. See *Thompson* v. *United States Dep't of Labor*, 885 F.2d 551, 555 (9th Cir. 1989); *Public Power Council* v. *Johnson*, 674 F.2d 791, 794 (9th Cir. 1982); *Dopico* v. *Goldschmidt*, 687 F.2d 644, 654 (2d Cir. 1982); *Natural Resources Defense Council* v. *Train*, 519 F.2d 287, 291 (D.C. Cir. 1975); *Appalachian Power Co.* v. *EPA*, 477 F.2d 495, 507 (4th Cir. 1973); *Tenneco Oil Co.* v. *Department of Energy*, 475 F. Supp. 299, 317 (D. Del. 1979).

This case thus presents a legal issue which has spawned substantial confusion and disagreement in several reasoned but conflicting opinions, and which is certain to recur as the government carries out its plan to become increasingly aggressive in its seizures. See *infra* p. 12. There is nothing to be gained by allowing the issue to percolate further; to the contrary, there is a powerful and immediate need for the uniform rule that only this Court can provide.

5. The decision below has particularly severe consequences for smaller institutions, such as those which comprise the NBA. When a conservator is appointed to manage a bank, its value drops immediately and its shareholders experience an immediate loss. William Seidman, former Chairman of the FDIC, has estimated that when a bank is closed, the value of its assets usually drops from 10% to 15%.[3] The potential for a government takeover is therefore an extremely important considera-

[3] Seidman, *The Facts About The FDIC*, Wall St. J., June 5, 1991, at A-12.

tion to those who are considering investing in a financial institution.

The Tenth Circuit's decision thus makes it much harder for less established financial institutions that serve minority communities—those with less ready access to capital to begin with—to attract the necessary investment. If an institution can be taken over by the government on the mere basis of an agency official's opinion, with the institution never given a fair opportunity to rebut that opinion, then the possibility of a sudden and permanent diminution in shareholder assets becomes very real. This creates substantial additional uncertainty and risk, and measurably discourages needed investment.

The Director's bland assertion (Opp. 9) that "only" 79 savings associations are likely to be placed in conservatorship or receivership in the near future hardly allays such concerns. In December, 1991, *Washington Post* interviews with the heads of the FDIC, OTS, the Resolution Trust Corporation, and the Office of the Comptroller of the Currency revealed that "[g]overnment regulators are poised to begin the biggest round of bank and savings and loan seizures in U.S. history" as part of a new strategy to "step in more quickly when signs develop that a bank or S&L is in trouble." Knight & Schmidt, *U.S. Shifts Bank, S&L Strategies*, Washington Post, Dec. 8, 1991, at A-1. Public announcements of that sort, coupled with judicial decisions that rob such institutions of the ability effectively to respond, have a considerable chilling effect in the capital markets and render the need for review by this Court especially pressing.

CONCLUSION

The petition for a writ of certiorari should be granted.

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